UNITED STATES-CHINA ECONOMIC RELATIONS AND CHINA'S ROLE IN THE GLOBAL ECONOMY

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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UNITED STATES-CHINA ECONOMIC RELATIONS AND CHINA'S ROLE IN THE GLOBAL ECONOMY

THURSDAY, OCTOBER 30, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 2:10 p.m., in room 1100, Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory, the revised advisory, and the revised advisory #2 announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
October 06, 2003
FC–9

CONTACT: 202–225–1721

Thomas Announces Hearing on United States-China Economic Relations and China's Role in the Global Economy

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on United States-China economic relations and China's role in the global economy. **The hearing will take place on Thursday, October 16, beginning at 2:00 p.m., and Friday, October 17, 2003, beginning at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building.**

Testimony on October 16th will be from invited government witnesses. Testimony on October 17th will be from private-sector witnesses. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

Since the United States and China established diplomatic relations in 1979, China has become an increasingly important trading partner of the United States and a major player in the global economy. Two-way trade between the two countries has increased since that time, growing from $4.8 billion in 1980 to $147.2 billion in 2002. In 2002, China was the United States' fourth largest trading partner, the third largest supplier of U.S. imports, and the seventh largest buyer of U.S. exports. The U.S. trade deficit with China was $103 billion in 2002, increasing by more than $20 billion between 2000 and 2002. Imports into the United States from other major Asian trading partners decreased by more than $40 billion during that same period. The United States is the second largest overall foreign direct investor in China. China is one of the world's fastest-growing economies, with an average annual growth rate of 9.3 percent. Reflecting its growing role in the world economy, China became a member of the World Trade Organization (WTO) on December 11, 2001, after many years of negotiations on its accession.

Since its accession to the WTO, China's integration into the global economy has proceeded rapidly and impacted its trading partners, including the United States. As a result, Congress, the Administration, and the U.S. private sector have focused on China's compliance with its WTO commitments, its trade balance, and the relationship between China's pegged currency and trade with the United States.

The goal of this hearing is to discuss China's importance as an economic partner to the United States and the issues surrounding the United States—China economic relationship. In announcing the hearing, Chairman Thomas stated, "China is an important player in the United States and the global economies. However, we need to ensure that China is integrating itself into the rules-based trading system that governs all WTO Members. During this hearing, we will focus on China's important role in the global economy as well as on China's progress in meeting its new trade commitments."

FOCUS OF THE HEARING:

The hearing will focus on United States-China economic relations and China's role in the global economy, with a narrower focus on the following: (1) implementation of China's WTO accession commitments (including issues relating to removal of quotas and tariff-rate quotas, export subsidies and discriminatory taxes on imports, and the use of non-tariff barriers to limit bio-engineered imports); (2) trade relations between the United States and China; (3) China's currency management; and (4) the relationship between trade with China and the U.S. economy, particularly the manufacturing sector.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Bill Covey or Peter Sloan at (202) 225–1721 no later than the close of business Wednesday, October 8, 2003. The telephone request should be followed by a formal written request faxed to Allison Giles, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515, at (202) 225–2610. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225–1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than 5 minutes. **THE 5-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record, in accordance with House Rules.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies, along with an *IBM compatible 3.5-inch diskette in WordPerfect or MS Word format,* of their prepared statement for review by Members prior to the hearing. **Testimony should arrive at the full Committee office, room 1102 Longworth House Office Building, no later than Tuesday, October 14, 2003, at 5:00 p.m.,** in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings. **Failure to do so may result in the witness being denied the opportunity to testify in person.**

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, by the close of business, Friday, October 31, 2003. Those filing written statements that wish to have their statements distributed to the press and interested public at the hearing should deliver their 200 copies to the full Committee in room 1102 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. Due to the change in House mail policy, all statements and any accompanying exhibits for printing must be submitted electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to 202/225–2610, in Word Perfect or MS Word format and MUST NOT exceed

a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Any statements must include a list of all clients, persons, or organizations on whose behalf the witness appears. A supplemental sheet must accompany each statement listing the name, company, address, telephone, and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at http://waysandmeans.house.gov.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

NOTICE—CHANGE IN TIME

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
October 08, 2003
FC–9 Revised

CONTACT: (202) 225–1721

Change in Time for Hearing on United States-China Economic Relations and China's Role in the Global Economy

Congressman Bill Thomas (R–CA), Chairman, Committee on Ways and Means, today announced that the hearing on United States-China economic relations and China's role in the global economy, previously scheduled for Friday, October 17, 2003, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held at 9:00 a.m.**

All other details for the hearing remain the same. (See full Committee Advisory No. FC–9, dated October 6, 2003.)

NOTICE—CHANGE IN DATE

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
October 14, 2003
FC–9 Revised #2

CONTACT: 202–225–1721

Change in Date for Hearing on United States-China Economic Relations and China's Role in the Global Economy

Congressman Bill Thomas (R–CA), Chairman, Committee on Ways and Means, today announced that the hearing on United States-China economic relations and China's role in the global economy, previously scheduled for Thursday, October 16 and Friday, October 17, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, **will now be held on Thursday, October 30 at 2:00 p.m., and Friday, October 31 at 9:00 a.m.**

Witnesses who are scheduled to appear before the Committee are required to submit **their testimony to the full Committee office, room 1102 Longworth House Office Building, no later than Monday, October 27, 2003, at 5:00 p.m., in an open and searchable package 48 hours before the hearing.**

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Please Note: Due to the change in House mail policy, any person or organization that is not scheduled to appear before the Committee and wishes to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225–2610, by the close of business, Friday, November 14, 2003.

All other details for the hearing remain the same. (See full Committee Advisory No. FC–9, dated October 6, 2003 and No. FC–9 Revised, dated October 9, 2003.)

Chairman THOMAS. If our guests could find seats, please. We apologize for the delay. As you know, there is activity in another House office building, but there apparently is some difficulty in some of the witnesses being able to get into the building. So, we will begin, and hopefully by the time we get to our first panel, the U.S. Trade Representative (USTR) spokesperson will be able to be with us at the table.

Today is the first day of a 2-day hearing on U.S.-China economic relations and China's role in the world economy. Perhaps the tension and concern about the global economy and China's role can be put in its proper perspective, perhaps, as we get news such as this morning that we received further evidence that the U.S. economy is improving. Apparently our gross domestic product (GDP) is up 7.2 percent in the last quarter, which is the highest growth in 19 years. The growth apparently came from strong consumer spending. I am sure a number of consumers were spending on items that were made in China, which will be part of the discussion that we are going to have.

Increases in business purchases of equipment, another item that we will be discussing, in which China is beginning to play an even greater role; and this is a bright spot, strong exports, with the hope that increasing exports are going to China.

So, it is relevant with that backdrop to look at the U.S. trade with China, our trade balance, and the role that China is going to be playing. It is clear to me that recently enacted tax cuts originating in this Committee and signed by the President have had a strong positive effect on that economic growth by spurring that very same spending and investment.

I want to start this hearing by saying this unequivocally: China is an increasingly important economic partner for the United States. China is today the United States' fourth largest trading partner, sixth largest market for our goods, and we must make sure that China keeps its commitments and acts in a fair and transparent way as she continues to integrate into the global economy. With this emerging prominence comes greater scrutiny of China's actions, either as a cause or an effect.

The goal of this hearing is to examine these issues and try to put them in their proper perspective. It means that there are going to be problems, as there are with every major trading partner, but that we should not begin to think of China as a scapegoat for systemic problems in the United States, some of which are in our tax code, or for our failure to further integrate the global economy.

In particular, I would like to say that at the end of the 2 days of this hearing, we were able to explore other policies and pursue other avenues to make sure that the United States itself can be more competitive internationally, such as reducing U.S. tax burden, delivering reliable and affordable energy, making sure that we have a climate in the area of health care costs and others that keep American employers in the United States, and that we create more jobs for more Americans while further integrating our trade with China and growing our world economy.

With that, I briefly yield to the Chairman of the Subcommittee on Trade, Mr. Crane, prior to recognizing the gentleman from New York, Mr. Rangel.

[The opening statement of Chairman Thomas follows:]

Opening Statement of the Honorable Bill Thomas, Chairman, and a Representative in Congress from the State of California

Today is the first day of a two-day hearing on U.S.-China economic relations and China's role in the global economy.

China is an increasingly important economic partner for the United States. In 2002, China was the United States' fourth largest trading partner, seventh largest market for U.S. exports and third largest supplier of U.S. imports. As one of the world's fastest-growing economies, China is a valuable and growing market for U.S. exports and is an important provider of inputs and products for U.S. manufacturers and consumers.

With this increasing prominence, however, comes greater scrutiny of China's actions as it further integrates into the global economic community. Several concerns have been raised regarding the U.S. trade balance with China: 1) the impact of the Chinese currency's peg to the U.S. dollar, 2) China's compliance with its WTO accession commitments, and 3) the relationship between China and trade, with a particular focus on U.S. manufacturing.

The goal of this hearing is to examine these issues to determine what impact they have on U.S. manufacturers, exporters, businesses and consumers and to discuss remedies available to deal with real problems facing U.S. companies.

We must make sure that China keeps its commitments and acts in a fair and transparent manner as it further integrates into the global economy. If there are trade problems with China, these problems must be addressed and corrected. That said, however, I also believe that China should not be made a scapegoat for other systemic problems plaguing the U.S. and global economy. In particular, I want to explore whether there are other policies we should pursue to make our companies more competitive internationally, such as reducing the U.S. tax burden, providing relief on healthcare costs, delivering reliable and affordable energy and limiting litigation that cripples growth and jobs.

Mr. CRANE. Thank you, Mr. Chairman.

Today we start with some excellent news about the recovery of the economy, as you have noted, with a GDP growth up 7.2 percent, which is the highest in two decades. That says to me that Congress needs to stay the course in our tax cut and free trade legislation. The growth came from strong consumer spending, increases in business purchases of equipment, and strong exports, which bodes well for the concerns we have about our trade balance, particularly with China.

China has been an important trading partner for the United States since the two nations established diplomatic relations in 1979. Bilateral trade between the two countries grew from only \$4.8 billion in 1980 to \$147.2 billion in 2002. As noted, China is the fourth largest supplier of imports, sixth largest market for exports, and overall the United States' fourth largest trading partner in 2002. It is estimated that by the year 2005, China will have more than 230 million middle-income consumers whose combined retail spending will exceed \$900 billion, meaning that China's market will offer tremendous opportunities for U.S. exports. Additionally, China is an important supplier for imports and products for the U.S. market. Although the U.S.-China economic partnership is important, it is also essential that China adheres to the commitments that it made in joining the World Trade Organization (WTO).

I have read recently that China will soon announce its pledge to purchase billions of dollars in U.S. goods in the next few years, including airplanes, jet engines, and auto parts. While this is beneficial for some U.S. interests, it will not replace China's WTO commitments to open its market.

China must not be permitted to backslide on its pledges as there is much that still needs to be done so China becomes a fully integrated player in the world economy. We must enforce our rights.

At the same time, we must consider other policy responses to problems that can be attributed to the domestic recession, slow growth globally, and U.S. tax laws that make our companies uncompetitive. We should not resort to protectionism. I am very much concerned by some legislative proposals that would impose punitive tariffs on China. Such tariffs would invite counter-retaliation and would penalize many U.S. interests, including U.S. consumers.

It is my hope that we will leave this hearing with a clearer understanding of the issues involved in the U.S.-China economic relationship and a better appreciation for what really impacts the bottom line for U.S. companies and consumers. Thank you, Mr. Chairman.

Chairman THOMAS. Thank the gentleman. Gentleman from New York, Mr. Rangel.

Mr. RANGEL. Mr. Chairman, I want to thank you for calling this meeting and welcome the distinguished guests that we have from the Administration, and also yield to Mr. Levin whose leadership was necessary in bringing together a bipartisan coalition in order to get support to make our trade relationship with China permanent. I yield to Mr. Levin.

Mr. LEVIN. Thank you, Mr. Rangel. Mr. Chairman, I am very glad we are having this hearing. We welcome our guests in the Administration and those who will come after. I apologize for my voice, which I think will last at least through this panel.

When we put together and passed Permanent Normal Trade Relations (PNTR), there were some assumptions, I think, widely held. One was that we needed both to engage China, a huge country with a growing economy, an important place in Asia and the world. We need to engage China, but also to confront it. Also a second assumption I think that was widely held, and that was that China would not only be potentially a major market for American products and American investment, but also it would be a major competitor. Surely the latter has been true.

So, I have joined many in watching China grow. I have also watched it act in ways that have increasingly concerned us as to its WTO commitments. I would like to chat a bit about—and I ask, Mr. Chairman, that my full statement and a statement referred to therein be part of the record.

Chairman THOMAS. Without objection.

Mr. LEVIN. Let me indicate a few areas of concern. There have been many, I just want to pinpoint a few. China has used its, quote, administration import licensing rules as a way to keep out imports it did not want to come in. It has also used fat taxes to discriminate against imports, including U.S. semiconductors. It has continued to restrict trading rights and, very importantly, there is hard work on this, distribution rights effectively limiting trade on U.S. products throughout China.

It has used standards and other technical product regulations as non-tariff barriers. It set up barriers to the establishment and expansion of U.S. service providers, and that was true, for example, in auto financing. Recently it issued a draft development policy for the auto industry that is filled with potential use of subsidies, of product standards, and so forth. My concern has been—that is, to these problems and others—that the Administration has relied basically on rhetoric that might be called "job owning," and not use of methods that are in the regulations. That are in the laws, that are within our laws and those of the WTO.

So, I am afraid up until now that, while the Administration may get a passing grade for its rhetoric, I think it gets a failing grade for action when it has come to these problems with China.

I want to briefly just remind us of the tools that have been available. One is the special safeguard that we labor to place within PNTR. It was the broadest safeguard ever put into American law to make sure that there would not be surges of imports from China that would unduly harm American businesses and workers. Up until now, the Administration has refused to use that special safeguard, turning down United States International Trade Commission (USITC) recommendations in two cases.

There was put into the legislation an annual report by the USTR. I have been disappointed by the lack of strength in real substance.

Thirdly, we put into PNTR a requirement that we negotiate a special annual review within the WTO. Otherwise there is going to be a review of China's commitments only every 4 years. To the credit of the Administration, they worked to get this into the final accession agreement, but it hasn't been effectively used. It is there.

It is important. China has said, in response to complaints, they won't put anything in writing. In some cases, they haven't even verbally responded, and our country has been too compliant with that.

We have a section 301 process that allows us to formally inquire into these problems, and that hasn't been used, nor has the formal dispute settlement system within WTO.

I want to close by saying a word, and we are going to talk about this—about the currency manipulation. The report came out today, I think it was, the formal report, and I have read it quickly. It talks about a number of countries, including China and Japan. As to Japan, it has no recommendation. It has no proposal of action. It was only a few months ago that the New York Times reported this. By spending trillions of yen to buy dollars in the foreign exchange market, Japan has limited the yen's rise against the dollar this year to no more than 2.3 percent. This rigging of the currency market by Japan hurts American manufacturers and their workers. The references in the report—and I am almost done, Mr. Chairman—and that is why I think there has been much too much reliance on rhetoric and there has been no reliance on the effective use of these mechanisms that are already in place.

So, I look forward to hearing the testimony and I hope this hearing will move the United States to more effective action. Thank you.

[The opening statement of Mr. Levin follows:]

Opening Statement of the Honorable Sander M. Levin, a Representative in Congress from the State of Michigan

Over the past several years, the U.S. trade and investment relationship with China has grown significantly. We often think about China only as a potential market. But this is a narrow view, we must also recognize that China is a competitor—for jobs, investment, and production. China's accession to the WTO helped address both of those facets of the relationship—China agreed to open its markets to U.S. goods and services and at the same time it agreed to be bound by a thorough set of rules establishing acceptable terms of competition with the rest of the world.

I have taken an active interest in ensuring that China plays by the rules—that it complies with its WTO commitments and that U.S. manufacturers and producers have a fair shake in China. Over the past several months I have become increasingly concerned that China is not complying with its WTO commitments and is in fact trying to give itself an unfair advantage.

I have also become concerned that the Bush Administration is not effectively using the tools available to it to maximize the pressure on China. In the 2004 currency manipulation report issued today by the Treasury Department, it talked about "serious engagement" with China. This type of phrase is often used as an excuse for a lack of real action and progress. There are tools and institutional frameworks available for engaging and pressuring China, and the Bush Administration is not using all of them effectively. **The Bush Administration may get a passing grade for rhetoric, but it gets a failing grade for action when it comes to trade and related economic issues with China.**

China Not Living Up to WTO Commitments

A few weeks ago, I had a chance to speak on China's WTO compliance at some length. I ask unanimous consent that my earlier comments be submitted to the record as part of my statement today. To briefly summarize the points in these comments:

China has used its quota administration and import licensing rules as ways of keeping out undesired imports.

China has used VAT taxes to discriminate against imports, including of U.S. semiconductors.

China has continued to restrict trading rights and distribution rights, effectively limiting trade in U.S. products throughout China.

China has used standards and other technical product regulations as a non-tariff barrier.

China has set up barriers to establishment and expansion to keep out U.S. service providers, including in the auto financing sector.

China recently released a draft "Development Policy for Auto Industry" setting forth a proposed industrial policy that would use subsidies, product standards, technology transfer requirements, import barriers and other tools of state control to advantage domestic production of autos and auto parts.

China has moved toward compliance in some important respects, but in others, there is non-compliance and bending of the rules in support of what is essentially a mercantilist industrial policy to the detriment of U.S. workers, farmers, and businesses. It is necessary for America to adopt a more active approach.

Bush Administration's Failure to Act

It is remarkable that in the face of China's non-compliance, the Bush Administration has refused to use all of the tools that the U.S. bargained for.

As part of the China PNTR deal, we included a special safeguard so that U.S. industries would not be injured by surges of imports from China. But, the Bush Administration has denied relief to both U.S. industries which the independent ITC found to be injured by Chinese imports.

The China PNTR bill also required the USTR to report annually on China's WTO compliance. To date, the annual report has not been used effectively as part of a comprehensive strategy to pressure China to come into compliance with its WTO commitments.

The China PNTR bill also called for a special annual review in the WTO of China's commitments—the idea here being that the U.S. could work with other countries to bring multilateral pressure to bear on China. Unfortunately, China has blocked effective use of this specially-negotiated review, refusing to provide written (and sometimes any) answers to questions or giving vague and evasive answers. The Bush Administration has essentially acted as if resigned to continuing uncooperativeness by China.

The Bush Administration has also failed to use other tools at its disposal. U.S. law establishes a "Section 301" process which creates a formal way in which USTR can bring pressure on China, with the threat of additional action should China fail to comply with its trade obligations. The Section 301 mechanism has been very useful in the past to open foreign markets. USTR has not used the Section 301 tool against China.

Nor has USTR initiated formal dispute settlement consultations with China in the WTO or brought any WTO dispute settlement cases against clear violations of the rules by China.

Today the Treasury Department issued its semi-annual 3004 report on currency manipulation. To date, the Treasury Department has given a free pass in this report to countries like Japan and China that maintain undervalued currencies in order to gain a trade advantage. For the first time, this report stated that China's currency policy was inappropriate and should be changed. The report did not, however, come out and state what needs to be stated—that China's currency is undervalued, which hurts U.S. manufacturers. The report also gave a free pass to Japan once again—despite the fact that, unlike China, Japan does not have a currency peg to explain its massive interventions.

The Treasury Report also notes the creation of a new "Technical Cooperation Program" between the U.S. and China. U.S. manufacturers have been complaining about China's undervalued currency for years now. This issue does not require study and delay; it requires action.

The U.S. has many tools with teeth available to deal with the various trade problems we have with China. The Administration has failed to use these tools, however, instead preferring to rely on rhetoric. The failure of the Administration to take concrete actions, however, has left a vacuum, which is being filled not only by the rhetoric of the Administration, but by a growing chorus of voices. If we take on these problems with the tools available to us now, we can make progress on trade and related economic issues with China. If we are content with rhetoric, we will not help U.S. manufacturers, farmers and workers, and the growing chorus of voices may result in situations that cause more serious problems in the future.

Chairman THOMAS. Thank the gentleman for his comments. Our first panel consists of the Honorable John B. Taylor, who is the Under Secretary for International Affairs at the U.S. Department of the Treasury; Dr. N. Gregory Mankiw, who is Chairman of the Council of Economic Advisers; and Ambassador Josette Shiner, who is the Deputy Trade Representative, Office of the USTR.

I want to thank you all for coming. This gives us a pretty good broad cross-section of the Administration. Any written testimony you have will be made a part of the record, and you can address us in any fashion you see fit in the time that you have. Why don't we start with the Department of the Treasury as the earlier created department, and then move across from my left to right, your right to left. Nothing intended by that.

STATEMENT OF THE HONORABLE JOHN B. TAYLOR, UNDER SECRETARY OF TREASURY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Mr. TAYLOR. Thank you very much, Mr. Chairman and Ranking Member Rangel, for inviting us to testify on this very important subject. Our economic relations with China are an important part of our overall economic strategy. The goal of that strategy is to strengthen the current economic recovery in the United States and to establish conditions that will lead to a long expansion in future years.

The tax cuts, which began in this Committee and which were enacted into law this summer, is an essential part of that policy, as are the President's proposals for tort reform, regulatory reform, and health care reform. Even with these policy reforms in the United States, there are significant barriers to economic growth in other countries, and these barriers affect the United States. That is why the international component of our economic strategy is so important. The strategy has been to urge countries to remove the rigidities and barriers that exist, wherever they exist, and to encourage pro-growth strategies that benefit the United States and the world economy.

This international strategy is built on bilateral relationships like our relationship with China. It also has a multilateral foundation. Our overall economic strategy is showing progress, as today's announcement of 7.2 percent growth in the third quarter indicates. Global growth is improving, too.

Despite this progress, we need to do more. That is why we have launched, for example, a new agenda for growth with the G–7 countries, and that is why we started up a new group for growth between the United States and Brazil. That is why we started up several new relationships in economic matters with China.

Exchange rate policy also has a bearing on growth and economic stability. Earlier today, the Department of the Treasury issued its latest report on international economic and exchange rate policies. This report examines exchange rate policies in major countries around the world.

Secretary Snow testified this morning on this report. The report reiterated our view that flexible exchange rates are desirable for large economies in our international financial system. The report documents that a number of countries continue to use paid exchange rates or intervene substantially in the foreign exchange market. The Administration strongly believes that a system of flexible market-based exchange rates is best for major economies. For this reason, the Administration is aggressively encouraging our major trading partners to adopt policies that promote such exchange rates.

For nearly 10 years now, the Chinese have maintained a fixed exchange rate to their currency relative to the dollar. The rate has been pegged at about 8.28 yuan per dollar for this entire period. China, in addition, has significant controls on capital flows. However, with its rapid growth, which has been referred to already, and its substantial foreign exchange reserve, China has an opportunity and is in a position to show leadership on the important goal of exchange rate flexibility and capital controls. If these relaxations took place, it would allow China to open the nation to capital flows and reduce imbalances, and we have been urging China to move in this direction.

We have also urged the Chinese to move forward in two other areas, reductions in barriers to trade and the removal of restrictions on capital flows. China's restrictions on capital flows are one of the major rigidities interfering with the market forces. The authorities understand this, we have worked with them, and they have begun to reduce these barriers to financial markets.

President Bush recently met with President Hu, and he discussed each of these economic issues and discussed the importance of reducing barriers to trade, to removing the restrictions on capital, and to moving to a flexible market-based exchange rate.

Secretary Snow traveled to Beijing this summer. He met with Premier Wen, with the Vice Premier Huang. He met with the Central Bank Governor Zhou and Finance Minister Jin. This visit of Secretary Snow, we believe, has achieved significant progress including new policy announcements by the Central Bank, reducing restrictions on foreign firms managing their foreign exchange, significantly liberalizing provisions to allow Chinese travelers to take foreign currency out of the country, examples of reductions on restrictions on capital flows.

The United States will continue to urge the Chinese to make rapid progress in these areas. We intend to continue both technical work and high-level talks on this subject with the Chinese. We have just established a new U.S.-China technical cooperation program in the financial area that will help China develop its financial markets infrastructure, including the foreign exchange market. The Chinese have agreed to interact with the G–7 financial officials on talks about economic issues.

In sum, I am pleased to report that our economic strategy is showing progress. Global economic growth has accelerated, led by an even stronger acceleration of growth in the United States. Our efforts to engage in financial diplomacy are generating constructive responses, though, as I indicated, more needs to be done. Active engagement with China and other countries is paving the way toward freer markets. This Administration's effort to raise growth in the United States and abroad and thereby create jobs at home is succeeding. Thank you very much.

[The prepared statement of Mr. Taylor follows:]

Statement of the Honorable John B. Taylor, Under Secretary of Treasury for International Affairs, U.S. Department of the Treasury

Chairman Thomas, Ranking Member Rangel, Members of the Committee, thank you for giving me the opportunity to testify on economic relations between the United States and China and on China's role in the global economy.

International Economic Strategy

Our economic relations with China are an important part of our overall economic strategy. The goal of that strategy is to strengthen the current economic recovery and establish conditions that will lead to a long economic expansion in the United States. The economic expansions of the 1980s and the 1990s were the first and second longest peacetime expansions in American history, and with the right policies there is no reason to expect that the current expansion will not be as long or longer. The Jobs and Growth package enacted into law this summer, is an essential part of the policy, as are the President's proposals for tort reform, regulatory reform, and health care reform.

But even with these policy reforms in the United States there are barriers to economic growth in other countries. And these barriers have ramifications for economic growth in the United States. This is why the international component of our economic strategy is so important. The strategy has been to urge the removal of rigidities and barriers wherever they exist, and to encourage pro-growth and pro-stability policies that benefit the United States and the whole world. The international strategy is built on bilateral economic relationships, including, of course, our relationship with China. It also has a multilateral foundation, including the meetings of groups such as the G–20, where China is included, or the newly established talks between economic officials from China and the G–7.

Global Economic Recovery

Thanks to the recent fiscal and monetary policy actions, the United States economy is now expanding much more rapidly. Consumer spending is growing at a very strong pace, housing remains solid, and business investment is picking up. The latest data also show exports to be gaining strength compared with the first half of the year. The September employment data showed a promising increase in jobs as well.

Global growth is also improving. There is continuing evidence of stronger economic growth in the Japan, Canada, and the United Kingdom. An increase in business and consumer confidence in the Euro area is a welcome sign that economic recovery is on the way there too. Much of Asia seems to have bounded back from the SARS induced slowdown in the first part of the year. Growth in China recovered sharply in the third quarter following a decline in the second quarter. Growth in other emerging markets is also picking up as the number of crises is down, capital flows are up, and interest rate spreads are low compared with the late 1990s.

Pressing Ahead on the Global Economic Expansion

Despite this progress, we need to do more. Last month the G–7 launched a new Agenda for Growth. For the first time each G–7 country will take part in a process of benchmarking and reporting actions to spur growth and create jobs. Another example is the new United States-Brazil Group for Growth through which we will work together to identify pro-growth strategies at the micro as well as macro levels.

Exchange rate policy also has bearing on growth and stability. Earlier today the Treasury issued its latest Report on International Economic and Exchange Rate Policies. This report examines exchange rate policies in major countries around the world. The Report reiterated our view that flexible exchange rates are desirable for large economies. However, the report documents that a number of countries continued to use pegged exchange rates and/or to intervene substantially in the foreign exchange market. The Administration strongly believes that a system of flexible, market-based exchange rates is best for major economies. For this reason, the Bush Administration is aggressively encouraging our major trading partners to adopt policies that promote flexible market-based exchange rates combined with a clear price stability goal and a transparent system for adjusting the policy instruments.

The move by several large emerging market countries—such as Brazil, Korea, and Mexico—to flexible exchange rates combined with clear price stability goals and a transparent system for adjusting the policy instruments is one of the reasons we are seeing fewer crises and greater stability. We emphasize that the choice of an exchange rate regime is one where country ownership is particularly important. We also recognize that, especially in the case of small open economies, there are benefits from a "hard" exchange rate peg, whether dollarizing, as with El Salvador, joining a currency union, as with Greece, or using a credible currency board, as in Bulgaria.

The Economy of China and its Links to the United States and the Global Economy

Let me now address China's economy. Economic reforms in China have increased economic growth and transformed China into a major economy in the world, both in terms of total production and in terms of purchases and sales of goods with the rest of the world. Yet, with per capita income of only about $1,000 per year and with financial, legal and regulatory systems in need of reform, China still faces challenges in its effort to catch up with developed economies.

China's global current account surplus was under 3 percent of GDP in 2002 and declined to 1.8 percent in the first half of 2003. Despite the relatively small overall surplus, China has a large trade surplus with the United States. This means, of course, that China has a large deficit with the rest of the world. China's bilateral trade surplus with the United States was $103 billion in 2002 while China's trade deficit with the rest of the world was about $73 billion, leaving an overall surplus of $30 billion. Many imports from China are goods from other Asian economies that are processed or finished off in China before shipping to the United States and other countries. Other East Asian economies increasingly send goods to China for final processing before they are shipped to the United States. China accounted for 11 percent of U.S. imports in 2002, up from 3 percent in 1990. Meanwhile, the combined share of Japan, Korea and Taiwan in U.S. imports declined to 17 percent from 27 percent over the same period. Thus, the total share of U.S. imports coming from these four Asian countries has remained steady since 1990, actually falling slightly from 30 percent to 29 percent.

U.S. imports from China are about 1 percent of U.S. GDP, or 11 percent of total U.S. imports. U.S. imports from China have been increasing rapidly, between 20 and 25 percent in 2002 and 2003. In general, these imports result from China using low-skilled labor to assemble and process imported parts and materials originating in other countries—mostly from other Asian countries that have traditionally exported directly to the United States. Consequently, the share of U.S. imports from these other countries has declined just as China's share has increased. Asia's share of U.S. imports has declined slightly. Much of the increase in U.S. imports from China has come at the expense of imports that once came directly from other Asian countries.

At the same time, U.S. merchandise exports to China grew 21 percent in the first 8 months of this year. Growth has been especially rapid in recent years for U.S. exports to China of transportation equipment (including aircraft engines), machinery, chemicals, and semiconductors.

The U.S. trade deficit with China should be viewed in the context of the overall trade deficit of the United States. The U.S. trade deficit is spread across many countries of the world in addition to China. For instance, the overall trade deficit reached $468 billion last year with 1) the Americas accounting for $105 billion, 2) Western Europe $89 billion, 3) Japan $70 billion, and 4) China $103 billion. The U.S. overall trade and current account deficit is best understood in terms of the gap between investment and saving in the United States. If this gap were reduced through an increment in savings, the overall deficit could shrink as would the size of the bilateral deficits. Increased growth abroad is also crucial to increasing U.S. exports.

China's Exchange Rate Regime

For nearly ten years now, the Chinese have maintained a fixed exchange rate for their currency relative to the dollar. The rate has been pegged at about 8.28 yuan/dollar for the entire period. Thus, as the dollar has appreciated or depreciated in value relative to other currencies, such as the euro or the yen, the yuan has appreciated or depreciated by the same amount relative to these other countries.

To maintain this fixed exchange rate, the central bank of China has had to intervene in the foreign exchange market. It sells yuan in exchange for dollar denominated assets when the demand for the yuan increases and it buys yuan with dollar denominated assets when the demand for the yuan decreases. Recently the central bank has intervened very heavily in the markets to prevent the yuan from appreciating. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese government have risen by $171 billion to $384 billion (as of end-September).

This accumulation of foreign exchange reserves would tend to expand China's money supply, although in recent months the Chinese central bank has moved to reign in monetary expansion. Among other measures to sterilize reserve accumulation, the central bank has—for the first time—begun issuing central bank paper to restrict growth of the monetary base. Nevertheless, the broader money supply continues to grow very rapidly: M2 climbed 21 percent over the 12 months ending in September 2003.

It is also important to recognize that China still has significant capital controls. China's capital controls allow for more inflows than outflows, thus bolstering foreign exchange reserves. China is gradually loosening some controls, and outflows are likely to grow as new channels develop for Chinese to seek diversification and better returns than those offered by low domestic interest rates. Indeed, there is already significant leakage of capital. A relaxation of controls on outflows would reduce upward pressure on the yuan.

Economic Relations Between the United States and China

With its rapid growth and substantial foreign exchange reserves, China is now in a position to show leadership on the important global issue of exchange rate flexibility. China represents one of the largest economies in the world, and a flexible exchange rate regime would be a good policy for China. It would allow China to open the nation to capital flows and reduce macroeconomic imbalances. We have been urging China to move to a flexible exchange rate.

We have also urged the Chinese to move forward in two other areas: reductions in barriers to trade and capital flows. In the area of trade, it is important for China to fully implement, and even surpass, the commitments it made to the World Trade Organization. It is important that China continue to open markets to U.S. services, agricultural and industrial products, and to effectively enforce intellectual property laws.

China's restrictions on capital flows are one of the major rigidities interfering with market forces. The authorities understand this and are beginning to reduce barriers to capital flows and develop more open and sophisticated capital markets. They are also working to strengthen the banking system and liberalize capital flows in order to prepare for a more flexible exchange rate.

Secretary Snow traveled to Beijing last month to urge further progress. He met Premier Wen, Vice Premier Huang, Central Bank Governor Zhou, and Finance Minister Jin. He met again with the Finance Minister and Central Bank Governor last week in Mexico.

President Bush recently met with President Hu. He discussed each of these economic issues. He stressed the importance of reducing barriers to trade, of removing restrictions on the transfer of capital, and of moving to a flexible, market-based, exchange rate. Recently, both Secretary Evans and US Trade Representative Robert Zoellick traveled to China to stress the importance market opening, especially in the area of trade in goods and services. In an important recent development, Vice Premier Huang has accepted an invitation to come to the United States to engage in high-level talks with Secretary Snow.

All of Secretary Snow's meetings have been detailed and candid. He stated publicly, "the establishment of flexible exchange rates, of a flexible exchange rate regime, would benefit both our nations as well as our regional and global trading partners." The Chinese reported that they intend to move to a market-based flexible exchange rate as they open the capital account. The central bank governor stated publicly that reform of the exchange rate regime is a central part of their foreign exchange reforms.

Secretary Snow's visit to Beijing achieved significant progress, including new policy announcements by China's central bank; liberalized regulations for foreign firms managing their foreign exchange; and significantly liberalized provisions to allow Chinese travelers to take foreign currency out of the country and to do so more frequently. The United States will continue to urge the Chinese to make rapid progress in these areas.

We intend to continue both technical work and high-level talks and on this subject. We have just established a United States-China Technical Cooperation Program in the financial area that will help China develop its financial market infrastructure, including the foreign exchange market.

The Chinese and the G–7 agreed to engage in talks about these economic issues. This represents another example of how China, the United States and other affected parties can come together to work on an issue of vital interest to them all. The first meeting between senior officials from the G–7 and China's finance ministry and central bank took place in September in Dubai, where the Chinese economy, the G–7 economies, and other economic issues, were discussed. Further meetings will be scheduled on a regular basis with China, the United States and the other G–7 countries. After the Dubai meeting, China's central bank representative said that China is moving as fast as it can in its reform.

Conclusion

I am pleased to report that our economic strategy is showing progress: global economic growth is accelerating, led by an even stronger acceleration of economic growth in the United States. Our efforts to engage in financial diplomacy are generating constructive responses, though much more needs to be done. Active engagement with China and other countries is paving the way toward freer markets. The Administration's effort to raise growth in the United States and abroad, and thereby create jobs at home is succeeding.

Mr. CRANE [Presiding.] Thank you Mr. Secretary. Dr. Mankiw.

STATEMENT OF N. GREGORY MANKIW, PH.D., CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. MANKIW. Mr. Chairman, Ranking Member Rangel, and Members of the Committee, I thank you for the opportunity to testify on the subject of trade with China. This is an important and often misunderstood topic, and I applaud you for focusing light on it.

In a few minutes I would like to walk you through some of the data that describe U.S. trade with China, and I will be referring to those charts over to my right.

China's emergence as a major participant in world trade is fairly recent. As chart 1 shows, China's trade with the world was modest throughout the 1980s and early 1990s. Since then, both exports and imports have grown substantially. China's imports of goods are now roughly one-quarter of its GDP, well above the share for the United States and Japan.

China has much to do to open its markets to U.S. goods and services. This includes reducing trade barriers and respecting intellectual property rights (IPRs). Increased openness is good for both China and for the United States. Chinese consumers will have increased access to goods from around the world. Imports will challenge Chinese firms to improve their competitiveness, leading to higher productivity and higher wages for workers. As has been widely noted, the United States has a substantial bilateral trade deficit with China. This deficit should be kept in perspective.

In chart 2, at the same time that the U.S. trade deficit with China increased, the overall U.S. trade deficit with countries other than China also increased sharply. China's contribution to the overall trade deficit has actually fallen slightly in recent years.

Chart 3 shows that although U.S. export growth has been weak over the past 3 years, it would have been even weaker without China. Since 2000, U.S. exports to the world, excluding China, have fallen; but U.S. exports to China have grown rapidly.

To a large extent, increased U.S. imports from China reflect decreased imports of the same goods from other countries, as chart 4 shows. In textile and apparel industries, for example, China's increased share of U.S. imports has been more than offset by decreased imports from Hong Kong. Although the share of U.S. goods and imports from China has increased since 1990, the total share from the Pacific Rim, including China, has actually fallen; that is, imports from China compete most directly with imports produced in other Asian countries.

The challenges faced by U.S. manufacturing firms are related first and foremost to the recent business cycle downturn. This has been compounded by a long-term trend of strong productivity growth in manufacturing. The recent recession was the second mildest since 1960, but it has not been mild for manufacturers. The large decline in manufacturing output stems from the nature of the recession. Unlike previous downturns in which household consumption and housing slipped, the weakness this time was felt mainly in business investment and exports. Both of these are particularly important for manufacturing.

Looking back beyond the recent business cycle, the long-term downward trend in manufacturing employment primarily reflects substantial gains in manufacturing productivity. Manufacturing production more than doubled from 1970 to 2000. Manufacturing employment fell from 25 percent to 13 percent of total employment. Meanwhile, employment has moved into services where productivity growth has been slower.

When one decomposes the recent declines in manufacturing employment, it is hard to see trade with China as having played an important role. The five industries that have contributed most significantly to manufacturing job losses since July 2000 are computer and electronic equipment, machinery, transportation equipment, fabricated metal products, and semiconductor and electronic components. These are exports in terms of industry for the United States where imports from China are small. This reinforces the fact that U.S. job losses are more closely related to declines in domestic investment and weak exports than to import competition.

There is much evidence that the U.S. economy, including the manufacturing sector, is starting to pick up momentum, thanks in part to the pro-growth tax policy that the Congress and President have put in place. We saw evidence of that in this morning's GDP report.

Increased trade can further support higher growth. Trade is a win-win, benefiting both the United States and our trading partners. It is important, with the economic problems recently facing the U.S. economy, not to cause us to retreat to an open and growing system of world trade. Thank you.

[The prepared statement of Dr. Mankiw follows:]

Statement of N. Gregory Mankiw, Ph.D., Chairman, Council of Economic Advisers

Mr. Chairman, Ranking Member Rangel, and members of the Committee, thank you for the opportunity to testify on the important subject of the relationship between trade with China and the U.S. economy. I will also focus on recent developments in manufacturing and on the connection between these developments and trade with China.

To summarize quickly, trade with the world, and with China in particular, provides substantial benefits to the U.S. economy. It is important that China continues to take steps to strengthen our mutually beneficial trading relationship. For example, China needs to continue to open its markets to U.S. products and to safeguard U.S. intellectual property rights. These actions will further increase the mutual gains from our economic relationship with China.

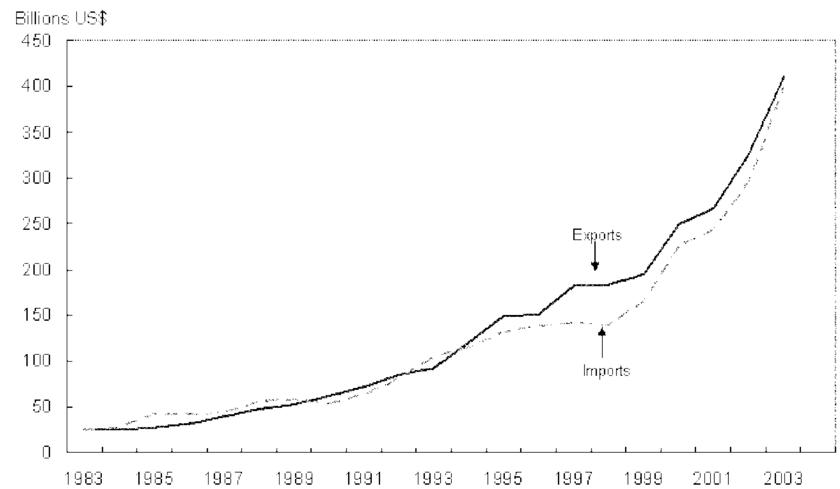
At the same time, the emerging importance of China in world trade has increased competitive pressure on some firms and industries in the United States. The Administration is committed to helping affected workers and their communities, including through enhanced trade adjustment assistance and personal reemployment accounts.

China's Trade with the World

China's emergence as a major participant in world trade is fairly recent. The volume of China's trade with the world was modest throughout the 1980's and early 1990's. Chinese imports and exports grew rapidly in the mid-1990's, however, and have increased even more dramatically since 2000. The level of Chinese imports and exports of goods has roughly doubled over the past five years.

The recent growth in China's trade has been fairly evenly divided between its growth in imports and exports (Chart 1). Although total Chinese exports have somewhat outpaced total imports since the early 1990's, this difference is small compared to the overall level of trade. Moreover, imports into China have recently increased slightly faster than Chinese exports, causing a reduction in its overall trade surplus.

Chart 1: China's Trade in Goods



Note: 2003 figures are through September annualized.

China's imports of goods are roughly one-quarter of GDP, well above the share for the United States and Japan (for which the comparable ratio is around 10 percent). China's increased demand for foreign manufactured goods and raw materials has been particularly dramatic. Chinese imports of both manufactured goods and raw materials have more than doubled over the past seven years. This increased demand has boosted exports and growth in many economies, especially in China's Asian neighbors and commodity exporters (such as Brazil and Chile).

The recent increase in Chinese imports has caused China to run trade deficits with many countries, including industrial countries such as Germany and Sweden. In fact, China's trade deficits with most countries are so large that the country has had a trade deficit with the world excluding the United States for several years.

China still has much to do to open its markets to U.S. goods and services. Although it imports and trades relatively more (as compared to GDP) than some developed economies such as the United States, China is less open to the global economy when judged by other measures. In particular, China has much to do to ensure that it abides by its WTO commitments. This includes continuing to open its markets and respecting intellectual property rights. This also involves ensuring that imports and foreign firms can compete fairly with domestic products in the rapidly expanding Chinese market. Increased openness is good for both China and for the United States. For the same reasons that we benefit from trade and from openness to the world economy, so will China. Chinese consumers will have increased access to a variety of products from around the world. Lower import prices will make incomes go farther and raise standards of living. Imports will challenge Chinese firms to improve their competitiveness, leading to higher productivity and thus higher wages and incomes for workers. These benefits of trade apply for both the United States and our trading partners.

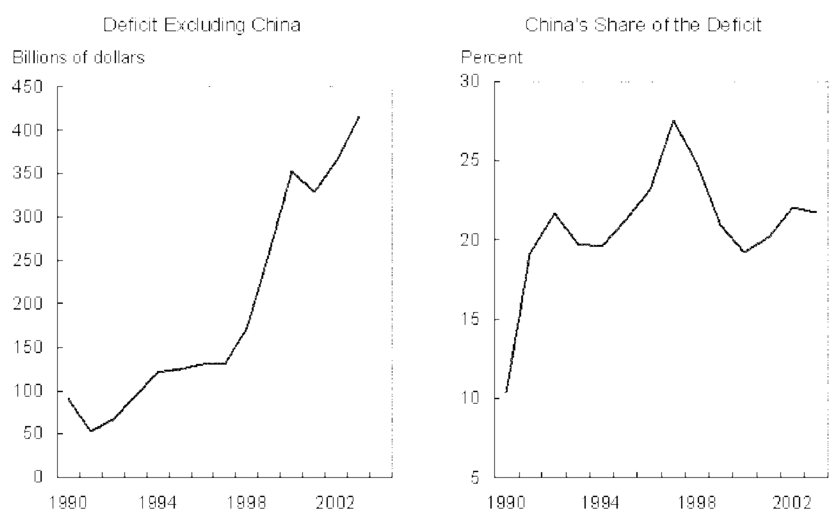
China's Trade with the United States

Trade linkages between the United States and China are substantial and important to both economies. The United States is China's most important export market and accounts for roughly one-quarter of all Chinese exports. U.S. purchases of Chinese goods have risen about 40 percent since 2000, reaching $152 billion (annualized) as of August. This year through August, China has been the second largest source of U.S. imports, after Canada but ahead of Mexico and Japan.

This growth in Chinese imports into the United States has resulted in imbalanced trade between the United States and China. The U.S. trade deficit with China in goods is large and more than doubled between 1995 and 2000. So far this year, the U.S. has a $125 billion (annualized) deficit with China, our single largest bilateral trade deficit.

It is important, however, to put this deficit with China into context. At the same time that the U.S. deficit with China increased, the overall U.S. trade deficit with all countries other than China also rose sharply (Chart 2). Our trade deficit with the world excluding China is almost four times greater than our deficit with China. In fact, China's contribution to the overall U.S. trade deficit has actually fallen slightly in recent years. China currently contributes about the same fraction of the overall U.S. trade deficit as it did about 10 years ago (Chart 2). Trade with China accounts for roughly one-fifth of the increase in the U.S. trade deficit since 1997—slightly less than the contributions from the Euro area or our partners in the North America Free Trade Agreement (NAFTA).

Chart 2: U.S. Trade Deficit in Goods

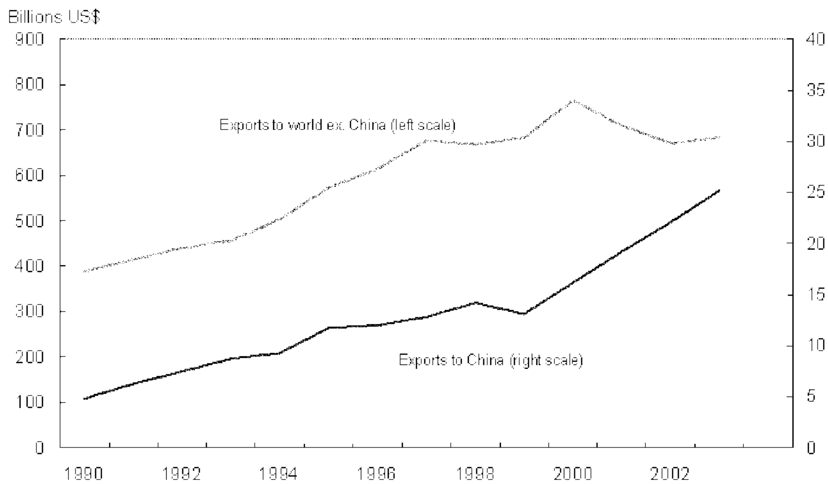


Note: 2003 figures are through August annualized.

Moreover, declining exports not rising imports account for the recent increase in the U.S. trade deficit. Over the past three years, U.S. manufacturing exports have fallen by about 10 percent, while imports have remained flat.

Without China, U.S. export growth would have been even slower. Although U.S. exports to the world excluding China have fallen since 2000, U.S. exports to China have grown rapidly over the same period (Chart 3). China was the seventh largest U.S. export market last year, ranking after South Korea and ahead of France, and is the sixth largest destination for our exports this year through August. Exports to China have risen over 55 percent since 2000, to $27 billion in 2003 (through August at an annual rate). Among the products that the United States exports to China are: $1 billion in oilseeds and grain (roughly 14 percent of all U.S. exports in this category), $1.3 billion in semiconductors and other electronic components, and $1.5 billion in transportation products (with statistics for this year through June).

Chart 3: U.S. Exports of Goods



Note: 2003 figures are through August annualized.

Increased U.S. imports from China partially reflect decreased imports of the same goods from other countries, instead of a net increase in the U.S. trade deficit. In other words, our imports from China replace imports from other countries rather than add to total imports. This pattern is clear for many major products we import from China. In the textile and apparel industries, for example, China's increased share of U.S. imports since the mid-1990's has been more than offset by decreased imports from Hong Kong. For other products, including footwear, toys and sporting goods, radios, and cameras, the increase in China's share of U.S. imports is roughly offset by a decline in imports from the rest of Asia. Indeed, although the share of U.S. goods' imports from China has increased since 1990, the total share from the Pacific Rim (including China) has actually fallen. This means that there has been an even greater decline in the share of U.S. imports from Pacific Rim countries other than China (Chart 4). That is, imports from China compete most directly with goods produced in other Asian countries.

Note: Pacific Rim countries are Australia, Brunei, China, Hong Kong, Indonesia, Japan, Korea, Macao, Malaysia, New Zealand, Papua New Guinea, Philippines, Singapore, and Taiwan. 2003 figures are through August annualized.

This is not to say that imports from China have no impact on firms in the United States. Chinese imports put pressure on firms competing with these imports and with the associated workers and communities. This is especially the case for firms that make items that are relatively intensive in the use of less-skilled labor, since these are goods in which China would be expected to have a comparative advantage. This advantage is reflected in the pattern of U.S. imports from China, which are mainly consumer goods—some 60 percent of the value of U.S. imports in 2003 through August—compared to only 28 percent capital goods imports. In contrast, U.S. exports to China and to the world as a whole tend to be goods that are made by relatively high-skilled workers: 47 percent of U.S. exports to China are capital goods, 35 percent are industrial supplies, and 10 percent are foodstuffs (foods are produced using fewer workers per unit in the United States than in other countries). On the whole, this suggests that imports from China mainly compete with products from developing countries.

U.S. Manufacturing Employment and Trade

The challenges faced by manufacturing firms are related first and foremost to the recent business cycle downturn. For workers, this is compounded by a long-term trend of strong productivity growth in manufacturing that has meant that increased manufacturing output can be produced without concomitant growth in manufacturing employment. International trade would rank as a third influence—and trade with China would be one component of trade.

While the recent recession was the second mildest since 1960, as real gross domestic product fell by less than 1 percent in 2001 from its peak at the end of 2000, manufacturers felt the economic slowdown first, the most, and for the longest. Manufacturing production began to slow in early 2000 and peaked in June of that year. It fell by about 7½ percent from June 2000 to December 2001 before it began to turn around. And while manufacturing production is now expanding, the number of workers is still shrinking.

A large part of the decline in manufacturing output stems from the nature of this recession. Unlike previous downturns in which household consumption and housing slipped, the weakness this time was felt mainly in business investment and exports. Both of these are particularly important for manufacturing.

The end of the high-tech stock market bubble and the corporate governance scandals of the past several years have particularly depressed business investment. This can be seen in the fact that the industries contributing most to the downturn in manufacturing are those primarily associated with the production of business capital goods. Computers and electronics, machinery, and metals account for half of the swing in manufacturing production from its rapid growth of the late 1990s to its decline after mid-2000. Nearly all business equipment represents manufactured products. In contrast, household expenditure, which makes up around two-thirds of final demand, involves a mix of goods, services, and structures. Manufacturing was thus particularly hard hit as a result of the nature of this business cycle.

With industrial supplies and capital goods accounting for the bulk of U.S. nonagricultural goods exports, slow growth overseas and the resulting lackluster demand for U.S. exports has hit the manufacturing sector especially hard. Indeed, lower exports of manufactured goods can explain the entire decline in overall exports since 2000. While growth in the United States has not been satisfactory, we have outperformed many of our leading trading partners, notably Japan and major economies in Europe.

Looking back beyond the recent recession, the long-term downward trend in manufacturing employment primarily reflects relative gains in manufacturing productivity that have not been offset sufficiently by increased purchases of manufactured goods. Although manufacturing production more than doubled from 1970 to 2000, manufacturing employment fell from 25 percent to 13 percent of total employment, as a result of gains in productivity. Given the level of manufacturing output in 2000, had productivity remained at 1970 levels, the manufacturing sector would have gained importance, rising to 38 percent of total employment. On the other hand, had trade in manufactures been balanced since 1970, with productivity at current levels, the share of manufacturing employment would have fallen by nearly as much as it actually did.

Imports from China are one of many factors that influence manufacturing employment. The five industries that have contributed most significantly to manufacturing job losses since July 2000 are: computer and electronic equipment (16.0 percent of all manufacturing job losses), machinery (10.8 percent), transportation equipment (10.7 percent), fabricated metal products (10.7 percent), and semiconductor and electronic components (7.5 percent). These are export-intensive industries for the United States where imports from China are small. This suggests that U.S. job losses are more closely related to declines in domestic investment and weak exports than to import competition.

The Outlook and Policy Responses

At the same time, it is important to recognize that trade can cause dislocation for some workers. The President has proposed a number of policies to help people affected by such economic changes. Notably, he has supported expanded trade adjustment assistance to help displaced workers gain or enhance job-related skills and find new jobs, including assistance with career counseling, training, income support during training, job search assistance, and relocation allowances. His innovative proposal for personal reemployment accounts will provide resources to workers most in need to help with the costs of training and adjustment. The proposed reemployment accounts would then offer a cash incentive for individuals to find work quickly, aligning public support with private incentives. The President has also worked with Congress to ensure that unemployment insurance benefits are available to people in need. These benefits provide important support for household incomes during difficult economic times.

There is a good deal of evidence that the economy is picking up momentum after three years of sub-par growth. Recent data suggest that conditions in the manufacturing sector may be starting to improve as well. Manufacturing production has edged up over the past several months. Shipments of capital goods rose strongly in the third quarter as a whole despite a small downtick in August, and orders remain above shipments, hinting at further growth ahead. The new orders index from the Institute of Supply Management's monthly survey of purchasing managers is now markedly above the level indicating expansion. Moreover, some of the factors that historically have affected firms' production decisions are supportive of a further firming in coming months—the cost of capital is extremely low by the standards of the last decade, and manufacturers' profits have risen substantially since the end of 2001.

Pro-growth tax policy has contributed greatly to the near-term recovery and to putting the economy on a better foundation for the future. Recent tax changes that give businesses greater incentive to invest will help many manufacturing firms, but the key is that the whole economy will gain as these initiatives lower firms' cost of capital and spur investment. Higher investment today means that tomorrow's workers will have more capital to work with. This makes workers more productive so that they earn higher wages.

The President has outlined a six-point plan to maintain the economic recovery and to boost long-term growth. This includes making health care costs more affordable and predictable; reducing the burden of frivolous lawsuits on our economy; ensuring a reliable energy supply; streamlining regulations; opening new markets; and enabling families and businesses to plan for the future with confidence by making the tax cuts permanent.

The actions he has proposed will boost growth in general, but manufacturing will benefit directly as well. The appropriate goal for economic policy is to support growth and to raise living standards. This stronger growth is good for manufacturing as it is good for the entire economy.

Increased trade can further support higher growth. Trade is win-win, benefiting both the United States and all of our trading partners. More trade means more choices and lower prices for consumers, and bigger markets for firms—in both directions. There is work to be done on this front, notably to further open Chinese markets to U.S. products, and to ensure that China fulfills its commitments under the World Trade Organization agreements, including its commitment to safeguard U.S. intellectual property rights. As discussed by my colleagues on this panel, the Administration is actively engaged with the Chinese to address these important issues.

Conclusion

Thank you for the opportunity to testify. I look forward to your questions.

Mr. CRANE. Thank you Dr. Mankiw. Now, Madam Ambassador Shiner.

STATEMENT OF THE HONORABLE JOSETTE SHEERAN SHINER, DEPUTY U.S. TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Ms. SHINER. Thank you Chairman Thomas, Congressman Crane, Ranking Member Rangel, and Members of the Committee. I welcome this opportunity to testify regarding U.S.-China economic relations, China's role in the global economy, and our trade relationship with China.

I have just returned from the second of two trips to China this month where I delivered the simple message: China must increase the openness of its market and treat U.S. goods and services in a fair and transparent manner if it wants to maintain support of the United States for an open market with China.

To address these areas, we are focused on three fronts: ensuring that China meets its WTO commitments and gets the fundamentals right as it moves to a rules-based economy; ensuring that our businesses and farmers exporting to China are treated in a fair and transparent manner; and ensuring that China effectively addresses the rampant pirating for domestic consumption and export of American ideas and innovations. What our producers and manufacturers and farmers want—what they are entitled to—are fair and consistent rules and a level playing field.

Last week, Ambassador Zoellick made his fifth trip to China as the USTR. Since my appointment in August, I have met with top officials in more than a dozen Chinese agencies to address outstanding issues and concerns. In addition to many meetings, last week Ambassador Zoellick and I met with Vice Premier Wu Yi where we emphasized the vital importance of meeting WTO commitments and addressing piracy issues.

I will return to Beijing in 2 weeks to lead the U.S. delegation in our second trade dialog with China this year, where we will address the range of our bilateral concerns. In addition, I will hold specialized meetings there with my counterparts to express our concerns regarding IPR enforcement and participate in the Ambassador's IPR Roundtable which will bring together the U.S. and the Chinese government and private sector officials.

In addition, Ambassador Zoellick, Secretary Snow, and Secretary Evans, who has just departed from Beijing, will continue to take advantage of additional opportunities to engage in a lead-up to Premier Wen Jiabao's visit to Washington in December.

To put the U.S.-China trade relationship in context, it should be noted that there are areas of achievement. Many U.S. manufacturers, service suppliers, and agricultural exporters report that China's large and growing market is their top area of growth. Companies such as General Motors import into China hundreds of millions of dollars of U.S. goods to meet consumer demand there, benefiting American workers and contributing to the company's overall strength. Indeed, less than 2 years after China's accession to the WTO, China has become our fourth largest trading partner and sixth largest market for U.S. exports.

In our trade with China, the United States ran a surplus of $1.1 billion in agricultural trade in 2002, and that surplus is projected to rise to $3.5 billion in 2003. The United States also runs surpluses with China in services trade, which was almost $2 billion last year. We have also seen growth over the past 3 years in U.S. exports to China of a number of manufactured products. Sales of machinery and electrical machinery have doubled over that period to $9.6 billion through the 12 months ending August 2003. We have also run a surplus in iron and steel. We sold nearly $1 billion of iron and steel to China in the 12 months through August of this year—an increase of well over 400 percent from 3 years ago.

Despite areas of progress, our deficit with China is our largest with any country, and it is growing. There is increasing concern in the United States and among our other trading partners that there are serious lapses in China's enforcement of its WTO commitments. Let us briefly review the current status of these issues, where we have made progress, and where we need to continue to press.

On WTO implementation, over the past 22 months China has taken many positive and sometimes difficult steps to meet its WTO commitments. It has implemented thousands of tariff reductions on schedule. It has reviewed and revised thousands of laws and regulations and established new transparency procedures and many national and sub-national agencies.

While much progress has been made, China's record of WTO implementation is too fraught with inconsistencies, delays, and enforcement weaknesses to demonstrate clear progress toward the rule of law. We are working with China on specific areas of concern, such as agricultural trade barriers, restrictions on the right of American firms to import and distribute products and services, and identifying the importance of upcoming commitments.

In the area of fairness in market access, China early on enacted a series of laws and regulations to protect patents, brands, and copyrights that are viewed as trade-related aspects of intellectual property rights (TRIPS) compliant by our industry. China's conspicuous failure to effectively enforce their laws and to enact deterrent penalties has made U.S. companies vulnerable to rampant counterfeiting and piracy. This is greatly undermining China's credibility as a fair market and threatening their own efforts to develop knowledge in innovation industries.

During our meetings, China pledged to address these issues at the highest levels and has put Vice Minister Wu Yi in charge of a leading group responsible to get this issue under control. We consider this an important step, given her standing in the leadership, her expertise on trade, and her effectiveness in dealing with the severe acute respiratory syndrome crisis when charged with bringing that under control. We will be working with her directly to identify best practices, vulnerabilities in their systems, and to help with training and capacity-building as they move to effectively enforce their laws.

We are aware that many U.S. firms, such as those in Congresswoman Johnson's district that are being threatened by pirating of their product, feel that they cannot wait for China to get the fundamentals right in this area. We know that many small- and medium-sized companies such as Zippo lighters do not have the resources to effectively investigate violations of their brands on the ground in China. To address their immediate concerns and yours, we have secured a commitment from our counterparts in China to investigate individual cases brought to their attention. We urge you to alert us to specific IPR problems, and we will work closely with you to address those problems with China.

We also highlighted other fairness concerns by conveying the frustrations of many U.S. service providers with China's restrictive regulations and U.S. exporters' concerns regarding China's apparently discriminatory value-added tax (VAT) policies. We have put China on notice that we do not feel that some of their VAT programs are WTO-compliant. I will seek to determine in November whether we can expect to have our concerns addressed.

On fair and transparent standards and regulations, as it implements its WTO requirements, we are urging China to build a transparent, open, and fair regulatory environment. In some sectors our companies report that they are seeing excellent improvements in the development of regulations; but in others, companies are frustrated with their attempts. In agriculture, we have pressed China to use only science-based sanitary and phytosanitary (SPS) measures. We are expressing the importance of regulating with technology neutrality, citing areas such as the wireless 3G field and the need for a fair approach in areas like basic versus value-added telecom services and automobile industrial policy.

In the area of enforcement of our trade remedies, as stated already, as a condition of China's entry into the WTO, China agreed to two separate China-specific safeguard mechanisms to allow WTO Members to cope with market disruptions caused by increasing economic integration with China. When our industry faces injurious trade with China, the Administration is fully committed to enforcing U.S. trade remedy laws and to exercising the important rights that the United States has under China's WTO accession agreement. To this end, the Administration has imposed duties under U.S. antidumping and safeguard laws against a range of products from China.

We have also raised the question of better cooperation on international economic issues, including in the WTO. We have had frank discussions with China on the progress of the Doha Development Agenda and will continue to engage China in an effort to promote our common areas of interest. China was a Member of the G–21 at a recent WTO Ministerial meeting in Cancun, Mexico. However, China also made some constructive interventions during those meetings, and as a Member of the Asia-Pacific Economic Cooperation (APEC) it has agreed with all other APEC Members that WTO Members should build on the Cancun text of September 13, 2003, which was a positive development.

Mr. Chairman, Members of the Committee, thank you for this opportunity to testify, and I look forward to your questions.

[The prepared statement of Ms. Shiner follows:]

Statement of the Honorable Josette Sheeran Shiner, Deputy U.S. Trade Representative, Office of the U.S. Trade Representative

Mr. Chairman, I welcome this opportunity to testify regarding U.S.-China economic relations and China's role in the global economy. I have just returned from the second of two trips to China this month, where I delivered this simple message: China must increase the openness of its market and treat U.S. goods and services in a fair and transparent manner, if it wants to maintain support in the United States for an open market with China.

During the last three weeks, I met with my counterpart at the Ministry of Commerce and with high-level officials from several other ministries to address critical U.S.-China economic and trade issues in the run-up to the October 19 meeting between Presidents Bush and Hu. I accompanied Ambassador Zoellick to the APEC Ministerial, where we bluntly and directly addressed these issues with Executive Vice Minister of Commerce Yu Guangzhou. I traveled with Ambassador Zoellick to Beijing for a meeting with Vice Premier Wu Yi, where we emphasized the vital importance of improving access to Chinese markets for U.S. manufacturers, service suppliers, agricultural exporters and their workers. And, we met with Governor Bo Xilai from Liaoning Province in Northeast China to discuss ways to increase agricultural trade and to improve intellectual property rights (IPR) enforcement.

I will return to Beijing in mid-November to lead the U.S. delegation in our second Trade Dialogue with China this year, where we will address the range of our bilateral trade concerns. In addition, I will hold meetings there with my counterparts to press our concerns about IPR enforcement, and participate in the Ambassador's IPR roundtable, which will bring together U.S. and Chinese government and private sector officials.

The Administration attaches great importance to improving China's openness to U.S. goods and services as a basis for building a healthy trading relationship. China's large and growing market offers tremendous potential for U.S. manufacturers, service suppliers and agricultural exporters. Indeed, less than two years after China's accession to the World Trade Organization, China has become our fourth largest trading partner and the sixth largest market for U.S. exports. We sold $22 billion in goods to China in 2002—up from $9.3 billion in 1994—and we should exceed last year's figure by more than 20 percent in 2003. Perhaps more significantly, exports to China have grown some 62 percent in the last three years, while U.S. exports to the world have declined by 9 percent over the same period. We are working to ensure that strong U.S.-China economic and trade ties benefit U.S. workers, farmers and ranchers.

Despite growing U.S. exports, our largest bilateral goods trade deficit is with China—and that deficit continues to grow. It stood at $103 billion last year and is running at an annualized rate of $125 billion so far this year. China will represent between 21 and 22 percent of our overall goods trade deficit with the world this year, like last year.

But while the bilateral deficit is large, it is worth putting those numbers into context. It should be noted, for example, that:

- Within the overall goods deficit, the United States ran a surplus of $1.1 billion in agricultural trade in 2002, and that surplus is projected to rise to $3.5 billion in 2003. The United States also runs surpluses in services trade. Last year, the services trade surplus with China was just under $2 billion.

- Much of the import increase from China has come at the expense of other Asian countries. In fact, when goods imports from China, Japan, Korea and Taiwan are combined, they actually represent a smaller share of U.S. global goods imports than they did in 1990, falling from 29 percent to 27 percent of the U.S. import market.
- China's economy is relatively open to imports. Imports as a share of GDP are 22.8 percent in China, 11.2 percent in the United States and 7.6 percent in Japan.
- And, as the National Association of Manufacturers and others have pointed out, imports are not bad for the U.S. economy. Goods that can be produced more efficiently in other countries provide a broad range of products to industry and consumers that enhance our standard of living.

The Administration is determined to continue to address market access problems that contribute to the deficit. Our markets are certainly open to exports from Chinese companies, and we need to ensure that China operates with fair, transparent and predictable rules when it comes to our companies' access to China's market. That means, most importantly, that China must live up to the commitments that it made upon joining the WTO. We also need to ensure that China engages in fair trade when it comes to its exports to the United States. Our companies want, and are entitled to, a level playing field.

The areas we have been pressing are:

- WTO implementation, including implementation of China's obligations to open its agricultural market and provide for full liberalization of trading rights and distribution services;
- Fairness in market access, such as providing for effective enforcement of intellectual property rights, lifting excessive restrictions on financial services firms, and non-discriminatory value-added tax policies;
- Fair and transparent standards and regulations, including science-based sanitary and phytosanitary measures and technology neutrality for new high technology products;
- Better cooperation on the international economic issues, including in the WTO; and
- Enforcement of U.S. trade remedies.

China's Implementation of its WTO Committments

China's accession to the World Trade Organization on December 11, 2001 was one of the most anticipated and hotly debated subjects in international economics of the last decade. By joining the WTO, China committed to a sweeping series of market-opening reforms that will require a fundamental shift in China's economy. While China had, for over two decades, been moving from a command economy to a more market-oriented economy, China's WTO accession was meant to be the crescendo to this movement.

For the United States, accepting China into the WTO served a number of purposes. The accession provided an opportunity to negotiate a favorable package of tariff cuts and the elimination of many non-tariff measures to open China's market to U.S. farmers, manufacturers, workers and service providers. China's WTO accession also subjects China to the same rigorous trade rules by which the United States and all other WTO members operate. The WTO has, for the United States, served as a valuable forum at which to address trade concerns with China. While we have yet to initiate dispute resolution proceedings against China, the United States has frequently used both formal and informal consultative mechanisms to achieve progress on many issues of concern to the United States. Indeed, the progress we have made toward resolving concerns with China's trading practices through such mechanisms is the primary reason we have not had to resort to WTO dispute resolution or other measures.

Of course, there are forces in China, as elsewhere, that are resistant to the changes wrought by WTO implementation. Despite the best of intentions by many Chinese officials, these forces have not been unsuccessful in limiting China's progress toward the goals the United States and other WTO members foresaw through China's WTO accession. As a result, China's market for U.S. goods and services is not as open as it should be, our engagement with China in the WTO has not been as useful as it should be, and China's record of WTO implementation is too fraught with inconsistencies to allow definitive statements on Chinese progress toward the rule of law.

Over the past 22 months, China has taken many positive and sometimes difficult steps to meet its WTO commitments. China has completed much of the nuts-and-bolts work of WTO implementation by reviewing thousands of laws and regulations and making necessary revisions to effect its WTO commitments, and by establishing new transparency procedures in many national and sub-national agencies. It has also reduced tariffs to their committed levels, and has begun the process of removing market access barriers affecting a wide range of goods and services sectors.

China's potential as a market for U.S. exports of bulk agricultural commodities was a key factor in U.S. support for China's WTO accession and grant of Permanent Normal Trade Relations status to China. While bumper harvests of some crops in China in 2002 may have limited the commercial potential of some U.S. exports, China's attempts to restrict certain agricultural imports has been a recurring problem since China's WTO accession. The use of—or even the threat to use—questionable GMO standards and sanitary and phytosanitary (SPS) measures to restrict imports of some products for alleged health and safety concerns has frustrated efforts of U.S. agriculture traders, most notably in the case of soybeans. In the case of those bulk agricultural commodities subject to negotiated tariff-rate quotas (TRQs) in China, the setting of sub-quotas, use of burdensome import licensing procedures, allocation of TRQs in commercially unviable quantities and a lack of transparency in TRQ allocation and management have restricted what should be a ready market for U.S. exports, particularly wheat, corn and cotton.

After the efforts of Ambassador Zoellick, Agriculture Secretary Veneman and others in the Administration, the commercial impact of these potential barriers was contained. U.S. exports of soybeans topped $1.2 billion—a record—and cotton sales were already 8–10 times greater than in any previous calendar year by July, 2003. In fact, as noted earlier, we are actually running a surplus with China in the agricultural area, which is projected to triple to $3.5 billion in 2003. Chinese officials have assured us that systemic problems with both GMO and SPS regulation will be addressed, and a negotiated settlement to our concerns with China's TRQ system is in progress. However, until solutions are successfully implemented, these issues will hang like a cloud over the marketplace. These and other emerging concerns will require continued vigilance and engagement by the Administration in order to ensure fair competition and market access for U.S. goods.

With regard to China's future WTO implementation, the top concern of many U.S. industries involves trading rights and distribution services. These were key areas for WTO members when negotiating the terms of China's entry into the WTO. Within three years after its WTO accession, or by December 11, 2004, China agreed to make trading rights automatically available, which means that U.S. businesses will be able to import and export goods on their own, without having to use Chinese trading companies. By that same time, China also agreed to fully open up the distribution services sector, which will allow U.S. companies to sell their goods freely in China, without being required to turn the job over to Chinese wholesalers and retailers or establish a joint venture with a Chinese enterprise. In the interim, China agreed to progressively liberalize in these areas pursuant to timetables set out in its accession agreement. So far, however, while China has begun the required liberalization, it has imposed stringent conditions, which have greatly limited the number of enterprises eligible to take advantage of the intermediate liberalization. China's "go slow" approach also raises concern that China will not complete full implementation of its commitments in these areas on a timely basis. The Administration is actively engaged with China on these issues—most recently in Ambassador Zoellick's meeting with Vice Premier Wu Yi—and has made clear its views on the importance of China's full and timely implementation of this important commitment.

Fairness in Market Access

In our meeting earlier this month with Vice Premier Wu Yi, Ambassador Zoellick and I stressed the importance of not just predictability and consistency but also fairness in the rules governing access to China's market. We explained that China's conspicuous failure to effectively address rampant counterfeiting and piracy greatly undermines China's credibility as a fair market. We also highlighted other fairness concerns by conveying the frustrations of many U.S. service providers with China's restrictive regulations and U.S. exporters' concerns regarding China's apparently discriminatory value-added tax (VAT) policies.

In the year leading up to WTO accession, China made significant improvements to its framework of laws and regulations protecting patents, copyrights, trademarks and other intellectual property rights. However, the lack of effective IPR enforcement in China is a major obstacle toward a meaningful system of IPR protection. IPR problems run the gamut, from rampant piracy of film and other entertainment products, to sophisticated software and semiconductor products, to counterfeiting of consumer goods, electrical equipment, automotive parts and pharmaceuticals. IPR infringements not only have an economic toll, but they also present a direct challenge to China's ability to regulate those products that have health and safety implications for China's population and international purchasers of such products. While a domestic Chinese business constituency is increasingly active in promoting IPR protection for self-interested reasons, the problem is immensely widespread. If significant improvements are to be achieved on this front, China will have to devote considerable resources and political will to this problem, and there will continue to be a need for sustained efforts from the United States and other WTO members.

We understand that Madame Wu Yi will be leading a new and more focused effort by China to tackle the IPR enforcement problem. In the view of the Administration, the key to making concrete progress on IPR enforcement will be for China to demonstrate a clear commitment to fight piracy at the highest levels, to increase deterrent-level criminal penalties for IPR violators, to show a willingness to increase prosecution and punishment of IPR offenders, to lower thresholds for criminal prosecution, to increase resources and devote more training for enforcement in all parts of China, and to establish more effective communication procedures between relevant officials of China's courts and investigative units, the Supreme People's Procuratorate and China's lawmaking bodies. I will continue to press our concerns in this important area later this month in meetings with my Chinese counterparts and with representatives of the U.S. and Chinese private sectors.

In the services area, several sectors have generated concerns, particularly regarding China's use of capitalization requirements that exceed international norms. The United States and China have had reasonably cooperative talks to resolve these concerns in many of the affected sectors, but progress has been slow and at times frustrating. Other issues, however, such as implementation of China's commitments on branching by insurance companies, the United States and China remain at odds. In addition, even when we have made progress toward resolving concerns with trade-restrictive regulations, as in the case of express courier services, we have sometimes had to revisit problematic issues in subsequently proposed measures.

Meanwhile, China has increasingly used VAT policies to encourage domestic industrial or agricultural production in a number of sectors. In the case of semiconductors, China's policy of providing rebates of VAT to domestic semiconductor producers disadvantages U.S. exports and raises significant WTO compliance concerns. In the case of fertilizer, China exempts from the VAT fertilizers that compete directly with the principal U.S. fertilizer export, a practice that is difficult to justify under WTO rules. In addition, we also have received reports about questionable tax policies used to promote exports of domestically produced agricultural goods, including corn. The Administration has engaged China on all these practices, and will continue to pursue the elimination of discriminatory or trade-distorting VAT policies through appropriate channels in Beijing, Washington and Geneva.

Fair and Transparent Standards and Regulations

One important incentive behind U.S. support for China's WTO accession was the role we foresaw WTO implementation would play in promoting transparency and the development of the rule of law in China. Indeed, in the first year of its WTO membership alone, China issued, modified or repealed more than one thousand laws and regulations to conform with WTO requirements. A China that plays by the rules of international trade, promotes more accountable government and is building a transparent, open and fair regulatory environment is a China that all Americans want to see.

While China has made significant progress in revising its legal framework, other problems have persisted. In particular, China has a poor record of providing opportunities for public comment on draft laws and regulations. In addition, many of the regulatory measures that China has adopted have been issued without advance notice and, in some cases, have unfairly prejudiced foreign companies and their goods and services.

Since China's accession to the WTO, we have repeatedly engaged China on the need for transparency in the operation of its trade regime, as China grapples with the fundamental changes required of it. And as we have witnessed how China has been implementing its new laws and regulations, we have urged China, for example, to use only science-based SPS measures. We have also stressed the importance of regulating with technological neutrality, citing areas such as the wireless 3G field, and the need for a fairer approach in areas such as basic versus value-added telecom services and automobile industrial policy, among others. We are committed to pursuing these efforts for as long as these problems persist.

Enforcement of Trade Remedies Laws

The rapid expansion of trade between our two countries has inevitably led in some cases to competition between our domestically produced goods and Chinese imports.

When our industries face injurious trade with China, the Administration is fully committed to enforcing U.S. trade remedy laws and to exercising the important rights that the United States has under China's WTO accession agreement, including our ability to continue to apply special methodologies to China under the anti-dumping laws.

China also agreed to two separate China-specific safeguard mechanisms to allow WTO members to cope with market disruptions caused by increasing economic integration with China. One such mechanism, the product-specific safeguard, was codified as Section 421 of the Trade Act of 1974, as amended, and is available until December 11, 2013. Since the implementation of Section 421, four petitions have been brought requesting import relief. In one case, the International Trade Commission found that our domestic producers' market had not been disrupted by imports from China. In two other cases, while the ITC found market disruption, the President determined that the adverse impact on the U.S. economy was clearly greater than the benefits from providing import relief. The fourth case is pending preliminary determination of market disruption by the ITC. While to date no import relief has been granted under Section 421, the President, in his most recent determination, reiterated his commitment to using the safeguard when the circumstances of a particular case warrant.

The second safeguard agreed to by China as part of its WTO accession package is an additional mechanism specific to textiles, and allows WTO members under certain circumstances to invoke limited import relief—specifically a 7.5 percent cap on growth in imports of a given textile category for up to one year (6 percent for wool products)—until December 31, 2008. The Administration is currently reviewing three requests under this safeguard mechanism, and initial determinations are scheduled for mid-November.

Broader Cooperation

As China becomes more integrated into the global economy, it becomes more important for the United States and China to work together to promote our mutual interests. We have discussed various ways in which we can cooperate on international economic and trade issues, particularly given our largely complimentary economies, and we have generally received constructive responses from China. Of particular importance at this time are the Doha Development Agenda negotiations. We have had frank discussions with China on the progress of those negotiations and will continue to engage China in an effort to promote our common areas of interest. I note that China was a member of the G–21 at the recent WTO Ministerial meetings in Cancun, Mexico. But, China also made some constructive interventions during those meetings, and as a member of APEC it has now agreed to build on the Cancun Ministerial text of September 13, 2003, which is a positive development.

Conclusion

Mr. Chairman and members of the Committee, thank you for providing me with the opportunity to testify. I look forward to your questions.

Mr. CRANE. Thank you. Before we proceed with questions, I just got the communication that the alarms that were set off with respect to a possible terrorist threat was a Halloween prank. A very stupid foolish thing, whoever was guilty of it, but apparently it was not serious. So, everyone can relax and breathe easy.

Let me turn to you, Mr. Secretary. The past recession was driven by a decline in capital investment, generally a U.S.-produced manufactured good. In addition to a weak economy in Japan—weak economy, rather, Japan and Europe has slowed down the demand for U.S. exports of manufactured goods, and Congress passed significant tax relief to encourage business spending. The recession has been over for almost 2 years. Are these tax cuts working to encourage investment, and is the global economy recovering?

Mr. TAYLOR. Yes. Yes. I think the tax cuts are encouraging this recovery. The tax cuts passed in 2001 prevented the downturn from becoming worse and got the economy moving again in a very difficult period, 9/11 attacks. For example, the reduction in stock prices that began in 2000, and the tax cuts passed this year are adding to that substantially, and we are beginning to see it now in the third quarter with the growth rate rising to 7.2 percent.

Globally, we are also beginning to see some pickups, not as substantial as in the United States. We are leading the way, but Japan is beginning to increase its growth rate. We see the British growth rate rising and some signs of acceleration in growth in Europe, but we need to work harder, and that is what we have tried to emphasize in the Administration, to have other countries around the world remove the barriers to growth. That is what we are working on and will continue to work on, sir.

Mr. CRANE. Thank you. Dr. Mankiw, while the productivity gains in the United States have been impressive to a macro-economist, they are bad news to millions of unemployed Americans. How fast must the U.S. economy grow in order to create, say, 2 million jobs? Aren't the productivity gains of late somewhat of a double-edged sword?

Dr. MANKIW. You are right that, in an arithmetic sense, for any given output growth, the higher the productivity growth, the lower the employment. I think we should think positively of higher productivity growth nonetheless, because it means that the economy is capable of growing faster. It means that we can push on the accelerator and let the economy grow without worrying about inflation. Higher productivity growth tends to keep down labor costs. It means that there will be higher real wages, and indeed throughout this business cycle, real wage growth has been strong.

There are different estimates about what productivity is likely to be going forward. It is probably going to be higher than it has been historically. Over the past 40 years, it has been around 2 percent. It is probably going to be higher than that, but it is good news; it means we can let the economy grow faster.

Mr. CRANE. Ambassador Shiner, do you think the China WTO compliance issues that have arisen thus far can be handled through negotiations with China, either bilaterally or within the WTO, or will some issues likely result in WTO dispute settlement proceedings?

Ms. SHINER. Congressman, as you know, we are 2 years into China's accession process and we have seen an increase in concern among our businesses and our farmers about their compliance situation. In the first year, we saw tremendous momentum in China as they worked to implement and change thousands of laws and regulations. There are a number of areas where we are concerned that either the laws and regulations that have been implemented are not consistent and not effective, and also they are losing some of the momentum in other areas.

We are certainly pressing them and working with them, and I hope to get an assessment in November on some of the really critical areas that we have pressed. We have seen a gap between what they have implemented and what their commitments were and whether or not we will see progress there or not. We are continually reviewing these, and we are prepared to use the tools necessary as we go through it, but of course it is far preferable if we can work directly with them to resolve these.

As I mentioned, in a few areas like the VAT, we think there is a serious gap in view on that, and I am not sure we will resolve that. Again, we will be taking an assessment in November as to where we stand on a number of key areas.

Mr. CRANE. Thank you, Mr. Rangel.

Mr. RANGEL. Thank you Mr. Chairman. Mr. Taylor, you commented on the recently passed tax cut bill. We have another one that left the Committee, $128 billion tax cut bill, ostensibly to remove the impediments that we have with the European Union and the WTO. Are you familiar with that bill? I am certain Ambassador Shiner has worked on it.

Mr. TAYLOR. I defer to Ambassador Shiner on this issue.

Mr. RANGEL. The bill is a tax cut bill. It removes tax liability for corporations overseas and domestically and takes us into debt an additional $60 billion. It is a $128 billion tax cut. The Ambassador will be able to tell you that. We were at risk for a $4 billion possible tariff from the European Union, but in order to resolve that, we got this bigger bill.

Do you believe the previous tax cuts have been so helpful as it relates to our economic recovery? I just want to get your view on this $128 billion tax cut. I don't want to believe that the Department of the Treasury is unfamiliar with the bill we just passed out.

Mr. TAYLOR. The tax cuts that I was referring to that have been passed have been very powerful.

Mr. RANGEL. I need your help on the one they are about to pass.

Mr. TAYLOR. They have a powerful effect. I would urge any of the actions taken in this area are aimed at improving the economy the way the tax cuts already have done so. I know these tax cuts are not finished.

Mr. RANGEL. It relieves corporate taxes. Like my friend Mr. Crane believes that we shouldn't have any corporate taxes at all and that corporations don't pay taxes, that people do. So, he welcomes the relief of $128 billion off of people by removing it off of corporations. You share that view?

Mr. TAYLOR. I think if you can find ways to reduce the marginal tax rates on activities that are helpful to people in the economy—and that includes a lot of the things that businesses do, invest in capital, invest in equipment so that workers can produce more and earn more—we should be encouraging that every chance we get.

Mr. RANGEL. Did the Thomas bill come across your desk at all?

Mr. TAYLOR. The Thomas bill is being discussed right now in this Committee, and we are very supportive of the activities going on in this area. I would just urge that whatever comes out that we focus on the important things, and that is to create jobs and get this economy going.

Mr. RANGEL. What you are saying, Mr. Secretary—and I wanted to get to China—but any tax cuts, you believe, would be of great assistance for our economic recovery. I thought you would be stunned by the $128 billion.

Mr. TAYLOR. Congressman, as you know, the efforts to find a way to resolve the WTO issue are focusing on ways to make up for the revenues in one area with others. We are supportive of doing that as close——

Mr. RANGEL. Make up for what revenues? We never lost anything with the WTO.

Mr. TAYLOR. The bills that you are working on now——

Mr. RANGEL. We would have saved $60 billion with the WTO repair. That is all we had to do there. Instead of that, we are coming back and giving tax cuts to both sides overseas and here, but you know that.

I am just saying that since that is done, do you believe that with the economy with what it is, that further tax cuts would speed up the economic recovery? I get the impression, quite honestly, that this Administration believes that tax cuts is the answer to economic recovery and that deficits really are not on the table at all.

Mr. TAYLOR. We are seeing right now the impacts of the tax cuts that were passed, and they are very powerful and are making a difference. This Administration has also made it very clear that as the economy recovers, the budget deficits will come down, and are projected to come down, and that is an important part of our policy as well.

Mr. RANGEL. Not in our lifetime, but I guess later it will. Ambassador, do you find the Thomas bill the solution to the problem that you and Ambassador Zoellick have been wrestling with with our friends in the European Union?

Ms. SHINER. We are pleased to see that this issue is moving. Our focus really has been on trying to be responsive to the foreign sales corporation (FSC) ruling in the WTO and move that forward. So, the Department of the Treasury has been the lead agency on it, but we are pleased with the efforts with this Committee and others, and we hope to get it resolved.

Mr. RANGEL. I can see why they give you people the title of Ambassador rather than just regular Secretaries and Deputy Secretaries. Thank you, Mr. Chairman.

Mr. CRANE. Thank you. Folks, I think we can wait another 5 minutes, but the bells just went off for a recorded vote on the floor. Let me yield first to Mr. Shaw, and we may even be able to get one more on the other side of the aisle before we get over there and vote.

Mr. SHAW. I hope I have a chance to get around to a question specifically relating to China, but I think that the observations and comments by Mr. Rangel deserve a rebuttal from this panel, and I will use most of my time in order to do that.

We are not only in a world economy, but we are in a world of competition. We are seeing and we are hearing a lot about it from both sides of the aisle here, criticism about our corporations and employers leaving this country because they find a better business climate in another country.

So, when you start looking at and going through the—each provision of the bill that this Committee passed just a couple days ago, you will see that it is more encouraging to stay in business in this country by the provisions of this bill; that we will become more competitive on a global basis to be the home base of employers, which we are now seeing that we are losing to such places as Bermuda and Mexico and some of these other places.

A lot of comment was made regarding the simplification of the foreign tax credit during the debate. Several observations I think we should make on that. One, it was bringing about fairness by reducing from nine baskets, a very complicated formula, to one which was much more simpler and easier to understand. Also it would tell the corporations that do have subsidiaries in other countries that they can keep their home base here and get a fair shot on the foreign tax credit. That is simply a reduction of those taxes based upon the taxes that they pay in other countries.

We know that—and we heard from the Department of the Treasury at that particular hearing that so much of the reason for having those subsidiaries in other countries was more about the laws and the attitudes in those foreign countries than about the question of exporting American jobs. I believe that.

I think it is about time that we look to employers as people that should be or companies that should be encouraged to expand here in the United States and we—just as cities do and just as counties do and just as States do all across this country, they encourage through tax laws investment within those States. We need to do that by encouraging investment here in the United States and growing jobs.

So, the fact that we are helping employers also means that we are helping the employment figures and we are helping employees, and that is what we want to do. We want to grow our job market, and that is a good thing.

I now want to just for one moment outline a situation pertaining to a constituent of mine that I have talked to Mr. Zoellick about, and I even brought it up before the Chinese Ambassador, but I get absolutely—it just doesn't seem—everybody listens very politely, but it doesn't have any effect. I have a longer statement regarding this that I would ask unanimous consent to place in the record.

Mr. CRANE. Without objection.

[The information follows:]

Mr. Ambassador, I want to talk to you about a trade dispute involving the Revpower Corp., which was owned by my constituent, Mr. Robert Aronsson. This matter has been ongoing now for well over a decade, and I ask for your help.

Allow me to briefly state the facts: In December 1989, SFAIC, a Chinese state-owned corporation, confiscated a factory owned by Revpower. In response, Revpower sought in 1993 and won a $4.9 million arbitration award from the Arbitration Institute of the Stockholm Chamber of Commerce against SFAIC.

When Revpower attempted to enforce the award with the Chinese court in Shanghai, that court refused to even acknowledge that the suit had been filed for 2 years. When the Shanghai court finally adjudicated the suit, it was only after SFAIC transferred its assets to its parent company, The Shanghai Aviation Industry, that the Court then dismissed Revpower's suit on that ground that FSAIC had filed for bankruptcy and accordingly there were no assets against which the arbitral award could be enforced. Four years later, the Xuhui Bankruptcy Court, found that the SFAIC and SAIC "conspired maliciously" to evade the enforcement of the arbitral award by transferring property from SFAIC to its parent SAIC. But by then it was conveniently too late for the Chinese government to grant any relief to Revpower.

As you are aware, China is required to enforce arbitral awards under the 1958 New York Convention on Recognition and Enforcement of Arbitral Awards. As SFAIC and SAIC were owned by the Chinese government at the time of the arbitration award. The Chinese government is bound by treaty to enforce and pay this award. Moreover, by failing to honor the Revpower award, the government of China ratified the violative acts of the Shanghai Court and thus breached its treaty obligations under the New York Convention. The net result is that what was initially a small commercial dispute has now become a situation whereby the injury to the

U.S.-owned entity stems directly from the Chinese government's willful violation of an international treaty.

This debt to Revpower by the Chinese government has been outstanding now for over a decade, and with interest, now exceeds $11 million. I contacted the previous Administration about this manner in writing on four occasions, with little result. Moreover, I asked your predecessor for her personal assurance that the office of the U.S. Trade Representative would vigorously pursue this matter with the Chinese, during a Ways and Means hearing in 2000, but nothing transpired.

Therefore, Mr. Ambassador, can you appoint a representative in your office to look into this matter, with the hopes of resolving this problem, instead of just endlessly managing a problem? China is ignoring its international treaty obligations, and small American businesses are getting financially hurt. I urge you to be aware of the overall problem of the Chinese ignoring international arbitral awards. I implore you to use your office to work with your Chinese counterparts to finally bring closure to this matter. Thank you.

Mr. SHAW. To summarize, in December 1989, Shanghai Far East Aero-Technology Import & Export Corp. (SFAIC), a Chinese-owned—state-owned corporation confiscated a factory owned by a company by the name Revpower. In response, Revpower sought in 1993 and won a $4.9 million arbitration award from the Arbitration Institute of Stockholm against SFAIC. The Chinese courts refused to enforce this award and the officers of the state-owned Chinese corporation then proceeded to deplete the company of its assets. This was flagrantly done, despite the fact that China is required to enforce arbitration awards under the 1958 New York convention on recognition and enforcement of such awards.

Ambassador Shiner, you spoke of the rule of law and respect of the rule law of other countries, and that is something we have to be very much concerned about. I don't know if you have any personal information or knowledge of this case. I would doubt that you do, but you are shaking your head yes, so maybe you do. I hope this will stay on the radar screens in our negotiations with China. If you care to comment on that.

Ms. SHINER. I am aware of the case and will continue to follow and work with you to resolve it. I will just say that on your earlier point about wanting to keep jobs in the United States, I think ultimately the U.S. market will remain incredibly strong just because we have the kind of infrastructure that we have built over 250 years that provides for a fair and judicial system, transparency in our laws, and regulations. It is America's strength.

As we move more into a global economy, more and more companies are going to remember why ours is a country you want to do business in: because our courts are so responsive. We do have a problem in China with the court system. A number of our companies report that, and it is one of the issues we will continue to press with China.

Mr. CRANE. Folks, let me tell you we have one 15-minute vote on the motion to adjourn, but there will be 5 minutes of debate and then three recorded votes after that. So, we will have a little time off here, and I hope I can get all of you back here after we finish voting. We will stand in recess subject to the call of the Chair.

[Recess.]

Mr. CRANE [Presiding.] Folks, we are going to be interrupted again they say within probably about a half an hour. So, while we have at least some Members here, let me yield at this point to our distinguished colleague on the other side of the aisle who is active in our trade issues, Sandy Levin.

Mr. LEVIN. Thank you. Thank you, Mr. Crane. We appreciate your waiting around for us here. You are all busy, important people. Let me just indicate as I talk to companies, workers, colleagues, I must say what is missing in Washington, and I think in your testimony is a sense of urgency. Let me just give you a few illustrations. Dr. Mankiw, you—one of you talked to Mrs. Johnson about what was happening in her district. There's been a similar dynamic in other districts. When you say trade is win/win; you can't say that to companies and workers that have been displaced.

I don't know why we use that language. You can favor expanded trade, feel the need to shape it, and not say it is win/win. I think that is especially relevant because I went over your five sectors, Dr. Mankiw, and it is interesting, when you look at what China has exported to the United States, that after toys, the next three are in the five sectors you mentioned: office machinery and computers, telecom and sound recording equipment, and electrical machinery.

So, more and more the competition from China is in the higher tech, the higher value added products. So, while it is true that productivity accounts for a lot of what we have seen, I think everybody has to expect that competition with China is going to be increasingly in those five sectors you mentioned. Isn't that true? That is the trend line, isn't it, away from footwear and toys being number one and two, and away more than anything else?

Dr. MANKIW. Let me respond to several things you said. I think when I say trade is win/win, I mean that allowing for free trade can sort of raise both countries' levels of economic prosperity, but you are absolutely right that the adjustment to that does cause workers to suffer some dislocations. I do talk about that in the written testimony as well. There are a variety of policies the Administration has pursued to address that issue. We have institutions like unemployment insurance, trade adjustment assistance, and the President has proposed personal reemployment accounts. The purpose of these kind of things is to help workers make the transition from certain industries to other industries, so that we can take advantage of what economists call the gains from trade, something that economists have understood really since Adam Smith.

Mr. LEVIN. How about shaping the terms of trade themselves? If you tell workers we will see you at the unemployment office, and we won't try to shape the terms of trade so there is some kind of balance; and if I might, just because the green light does turn to yellow, let me give you another example. I just did. Currency. Secretary Taylor, I must confess, anybody reading this report that came out today is going to—I think most people would be very disappointed.

As to Japan, you say the Japanese have stated that their intervention is carried out when excess volatility or overshooting is observed in the markets. Then you say you are actively engaged. They may say that, but aren't they rigging the market? When they spend trillions of dollars of yen to buy dollars, they are—it isn't just to react to excess volatility or overshooting. Isn't that true? Why do you say—why are you so soft?

With China, you just say it is not appropriate, but not anything you will do about it. What is the hesitation to say to Japan, stop intervening to keep your yen at a position that you gain a major export advantage? Why not say that?

Mr. TAYLOR. We are engaged in discussions all the time with Japan, and as this hearing has indicated, as we indicated with China——

Mr. LEVIN. Why not say it in this report?

Mr. TAYLOR. The report is a factual description of the interventions that have occurred. It is—they are given there, the numbers are given there. There is a statement about what the Japanese, how the Japanese describe it.

Mr. LEVIN. How about how we describe it?

Mr. TAYLOR. It is a statement about our engagement with them which is substantial and active and will remain so.

Mr. LEVIN. Okay. So, how do you describe it—and then my time is up. How do you describe the Japanese intervention in the market?

Mr. TAYLOR. Well, it is described in the report. It is factually described, and it is a way which I think is the best way to do it. What we have done is focus on the things that Japan needs to do to grow more rapidly so it creates global growth and that is—those are financial issues. For example, reforming the banking sector, for example, creating more liquidity. That will create growth in Japan and help jobs in the United States. Just if I could say one thing on China, very specific, in your opening remarks, sir, you mention this auto financing issue.

One of the things that we have just accomplished in our talks with China is—and this is an October issue, is they have agreed on the auto finance to regulations issued to allow non-bank institutions to provide auto financing. So, that is a very specific thing they have done in response to the discussions we have had with them. It is urgent, and it goes to the kind of issues that you are raising.

So, I think if you are looking at the progress we are making in our talks, they are substantial and they are specific and they are—we are making progress using the approach that we are taking now.

Mr. LEVIN. There is so much left undone. You don't give a sense of urgency to people who want to hear it. Thank you.

Mr. CRANE. Mr. Houghton.

Mr. HOUGHTON. Thank you very much, Mr. Chairman. Sorry again for the delay. Just a couple of points. I wonder whether we aren't being softies in this country. The other countries seem to be blocking off or not allowing Chinese goods to come into their country, and we seem to be the open sesame. We seem to be the place where the exports go to make up the difference. I always remember, Mr. Levin and I were talking about the Japanese situation, where something like 25 or 30 percent of Third World exports came into our country, and only 6 percent came into Japan. I wonder if the same phenomena isn't at work here with China, that we are opening up our markets. We are not demanding very much for it, and the others are really closing their markets. Can you comment on that?

Ms. SHINER. If I could comment. First of all, on the percentage of GDP attributable to imports, it is very interesting to note that China, it is about over 22 percent of their GDP is attributable to imports, ours about 11 percent, Japan about 7.6 percent. So, we are right about in the middle of that. Part of the reason that we import more than Japan does right now is our growth in this country has been much higher. Japan's economy has been very flat. If you look at the history of China's accession into the WTO, for example, it was the United States who really wrote into the accession agreement all of the tough provisions. We were the leaders in that.

We have been the ones who are really monitoring this most effectively. I just had meetings in Japan where we had a dialogue on their concerns and our concerns, and we were way ahead in monitoring and enforcing and working with China across the board on these issues. So, I don't really find that there are other countries in the lead on this. At the WTO and others, it is often us driving these. On IPR, it is the United States driving this issue globally. We are absolutely the leaders on enforcement of IPR. So——

Mr. HOUGHTON. I guess what I was getting at, maybe I didn't express myself clearly, that China has a negative trade balance with many countries. Not so with us. Why is that?

Ms. SHINER. With the United States?

Mr. HOUGHTON. No, well. Not the United States.

Ms. SHINER. They are current accounts basically.

Mr. HOUGHTON. Yes. Right. In other words their exports are coming in here but they are not going to other countries, or if they are, they are being offset with imports. Why is that phenomena? Why are we so unusual here?

Ms. SHINER. It is very interesting. If you look at the percentage of our imports from northeast Asia, China, Japan, Korea and Taiwan, it is less today than it was in 1990. What you have seen in many, many products is a shift from us importing from Taiwan and Korea and Japan in a number of product lines going to China, but the overall numbers are actually I think it was 27 or 29 percent in 1990, now it is 27 percent.

So, we are actually not importing that much more. I think our real problem is that the export opportunities for the United States have been very slow because of slow global growth. So, our key trading partners like Japan need to grow more.

Mr. HOUGHTON. So, what you are saying is that the European countries, or other countries dealing with China, have a balanced in and out so there is not a big difference the way it is in the United States because of their exports. Where we fall down is because we don't have similar proportional exports; is that right?

Ms. SHINER. Well, Europe also has a trade deficit. I don't have the figures right here with China. Their numbers are different than ours, but the effect or the size of it is quite impactful for them also. We need to close our deficit with China.

Mr. HOUGHTON. Now that is a given. That is a given, but I just don't understand the phenomena that the disproportion between imports and exports with China for the United States is so dramatically different than it is in most other countries.

Ms. SHINER. Well, right now we are buying the worlds' goods. The growth in our economy has benefited the countries that are doing this because we have a lot of the consumer demand. So, in Congressman Levin's district is the headquarters of K-mart. We have Wal-Mart, and you look in those stores, they are filled with these goods that benefit our consumers, but it also creates a problem when our other trading partners aren't also buying key U.S. goods because of slow growth.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. CRANE. Ms. Dunn.

Ms. DUNN. Thank you very much, Mr. Chairman. Are you hearing me through this microphone? Let me try this one. Thank you. I am sorry I missed the earlier part of this hearing due to all sorts of things, including a markup in another Committee. I am sorry. I apologize if I am asking you to repeat yourself. I am interested in pursuing the line of questioning having to do with IPR enforcement.

A few years ago when I first went to China, and I am in a district where I represent Microsoft, there was something close to 99 percent piracy of intellectual property. I am wondering how China is doing on its way to acceding to the WTO in that area. In the additional agreements that we have drawn up with China, how are they performing? I might ask anybody who is involved, but particularly the Ambassador.

Ms. SHINER. I had reported earlier in my opening statement that we have made, I think, some real progress in this area in this sense. When I was in China we have been raising this issue, and they have told us and we have met with Vice Premier Wu Yi that she will be in charge of a leading group on IPR enforcement. This is significant because we think a necessary condition for them getting on top of this problem, not sufficient, but necessary is high level attention and a commitment from the top to get this done.

So, we feel her involvement with this will be very important and we have met with her on this. In IPR, there is kind of three levels we are working on. One, we have rampant IPR violations throughout Asia and around the world. So, one question, one area we are working with all our trading partners there is to look at best practices and to work with those countries that have gotten on top of this problem and to share those best practices with our trading partners in Asia.

So, for example, we have been working with our industry and it turns out that Hong Kong has really turned a negative spiral on IPR around and gotten on top of their situation with very innovative measures. I will be going to Hong Kong in 2 weeks to study their methodology and then proceed on to Beijing for a day of discussions and negotiations on IPR issues, where we will be talking about these best practices and recommending efforts they can take to get on top of this situation.

In addition, we have been reviewing their laws and there are a number of areas, especially in the area of penalties, deterrent penalties, that are deficient. So, we are working with them to make recommendations and seek improvements in those areas. In addition, this problem takes place at the provincial level. So, part of what we are doing is working also on the provincial level and making the case that if certain provinces in China can get on top of this issue it will be a comparative advantage for them because right now there are a lot of U.S. companies that don't want to do business there because they are afraid their property will be stolen.

So, we had discussions with a governor of a province in northeast China about this and suggested that they really set a model and a pace in China for others to be able to emulate. So, we feel we have got to work on the national level there, on the legal level and on the provincial level to get on top of this.

In addition, to making the case that if they can't get on top of the problem, we will have to take stronger action.

Ms. DUNN. What would that action involve?

Ms. SHINER. There are, as you know, a number of tools that are available to us—enforcement measures—and we would be looking at what would be most appropriate. We do feel that with Vice Premier Wu Yi's attention to this, that we have really got some traction now and some possibility to work with them across the board on getting on top of this situation.

Ms. DUNN. Thank you very much. That will be of great interest to me as we pursue their accession to the WTO. Thank you, Mr. Chairman.

Mr. CRANE. Ms. Tubbs Jones.

Ms. TUBBS JONES. Thank you, Mr. Chairman. We only have 5 minutes so I am going to try and ask short questions to get short answers, if that is possible. I have recently been visiting businesses in my Congressional District after my appointment to the Committee on Ways and Means, including those in the northeast Ohio region. I visited Central Brass that makes little faucets. This company went from some 480 employees with three shifts down to 80 employees with one shift. I asked the man what he thought his biggest problem was, and he said China. I went to visit Rockwell Automotive, which is a multinational company doing very well and doing—enjoying the whole international relationship.

Then I went to Goodyear, which I am sure you know is the last remaining American manufacturer of tires. Tell me—let me start with Mr. Shiner, what should I be telling the—not Mr. Shiner, Ms. Shiner, the Honorable Shiner. I should be telling the man at Central Brass about what you are doing to assure that a little company like Central Brass should be able to stay in business while we are doing business with China.

Ms. SHINER. I find with the issue of trade with China we really have to take it company by company, and I am willing to work with you to figure out the case of each of those companies that you have mentioned. I am not sure, because I haven't looked at those cases, what the import figures are, what we are facing. I will tell you this, if there are unfair trade practices involved, we will act on those.

So, what I would suggest is that I follow up with you on those cases and we figure out what is at work there.

Ms. TUBBS JONES. That would be wonderful. In response to Ms. Dunn's question, you said there are tools for enforcement, and we are going to figure out which would be the most appropriate. What is the most severe tool that you could use against a company that is operating inappropriately from the Chinese government? What is the most severe tool?

Ms. SHINER. Well, we have the ability to bring cases in the WTO, to pursue that. We also have the ability, if there are unfair trade practices involved, to block imports.

Ms. TUBBS JONES. What has our record been with cases in the WTO?

Ms. SHINER. Overall? Not regarding China?

Ms. TUBBS JONES. Let's talk about China.

Ms. SHINER. Okay. Since their accession was only 2 years ago, we haven't pursued any cases in the WTO. What we have done is work across the board with our transitional review mechanism (TRM) in the WTO to bring up cases where we have enforcement issues and to work with them to implement them. So, we are working in the committees, the regular committees at the WTO to pursue those cases.

Ms. TUBBS JONES. Our record has not been very good, has it? A yes or no?

Ms. SHINER. I think we are early in this relationship. We are coming up to the 2-year anniversary. I do want to say——

Ms. TUBBS JONES. You know what? I really appreciate your response, but I would like to go to Dr. Mankiw, if you don't mind.

Ms. SHINER. Okay.

Ms. TUBBS JONES. You said in order to improve or increase jobs in the United States, we need to push the accelerator. What do you mean by pushing the accelerator, sir?

Dr. MANKIW. The economy has just recently gone through a very difficult business cycle, a series of adverse shocks that included the end of the high tech bubble, the corporate governance scandals, 9/11, and slow growth abroad, which has——

Ms. TUBBS JONES. Okay. I know all that, but what is the "pushing the accelerator"?

Dr. MANKIW. Well, the tools, the standard tools for stimulating the economy are monetary and fiscal policy, and over the past few years, we have seen monetary and fiscal policy acting hand in hand. The Federal Reserve's series of interest rates cuts and a series of tax cuts that the President proposed and the Congress passed are——

Ms. TUBBS JONES. So, I have—in Cleveland, Ohio since 2001 we have lost 50,000 jobs. In the State of Ohio since January 2001 we have lost 150,000 jobs. When we push the accelerator, what can I tell these people who are unemployed and who don't expect to get any extension of their unemployment what the accelerator means? Is it 2 months, 10 years, or 5 months?

Dr. MANKIW. Well, I think today we saw some of the effects of the monetary and fiscal stimulus.

Ms. TUBBS JONES. What does the accelerator mean in months? What do I tell my constituents, in 10 months you are going to have a job?

Dr. MANKIW. I think what you can tell them is that the Congress and Administration and the Federal Reserve are acting to get the economy going after a series of adverse shocks.

Ms. TUBBS JONES. Tell them don't hold their breath, right?

Dr. MANKIW. Pardon me?

Ms. TUBBS JONES. Tell them don't hold their breath.

Dr. MANKIW. No. I think you should tell them that the economy is now growing very rapidly. We just saw the best quarter for GDP growth in almost 20 years.

Ms. TUBBS JONES. You can't put it in a monthly term for me to help these people who don't have any money.

Dr. MANKIW. Traditionally there is lag between what we see in real GDP, and what we see in the labor market. So, one should fully expect by the end of the year to see some robust employment growth.

Ms. TUBBS JONES. Robust employment growth by the end of the year, for Christmas?

Dr. MANKIW. I believe we will, yes.

Ms. TUBBS JONES. Okay. Thank you, Mr. Chairman.

Mr. CRANE. Mr. Foley. Oh, I am sorry. Mr. English.

Mr. ENGLISH. Close call. Thank you, Mr. Chairman. I want to thank this panel for testifying. I must say, as I listen to some of the concerns from some of my colleagues on the other side of the aisle, I have to sympathize with them because I think we are at a very difficult time in our trade relationship with China. People in northwestern Pennsylvania are experiencing the same thing that people in northeastern Ohio are. With that in mind, I think it is very important that we get to some of the core issues in this conundrum of China trade. Mr. Taylor, I think that you touched in your exchange with Mr. Levin on the report that was released today on international economic and exchange rate policies with regard to China.

As I understand it, while the 1988 Trade Act (P.L. 100–449) provides some technical requirements for what you have got to find in order to claim there is currency manipulation. It is fairly clear that the Department of the Treasury's policy in meeting with China, the President's policy in meeting with Chinese leaders, and the USTR's policy is that China needs to reform its monetary policy. I realize that you came out today with the same finding the Department of the Treasury has made for the last 10 years. Is it not fair to say that Department of the Treasury is on record saying there is a problem with the way the yuan is fixed and that until there is a float or some other reform of the policy, that this is going to be a fundamental problem in our trade relationship with China?

Mr. TAYLOR. Yes, sir. The report does indicate that this is not the kind of policy that we recommend for large economies like China, and we are working with them right now to help them move off this policy, and they have indicated that they would like to move off it in the time lines that they will have to determine themselves. We are very actively engaged on this issue with them.

Mr. ENGLISH. Mr. Taylor, last night the U.S. House of Representatives passed a resolution on this subject with only one dissenting vote. I think it gave the Administration the ammunition to go back to the Chinese with a very powerful message. Is the Administration going to follow through and deliver to the Chinese the message that the Federal government is united on this issue?

Mr. TAYLOR. We will and have. We are going to continue to work the way we have and get the progress we are doing at many levels. You also mentioned the President, the Secretary of the Treasury, the U.S. Trade Ambassador, the USTR, and the Secretary of the U.S. Department of Commerce. Everyone is engaged on this, and we appreciate your support.

Mr. ENGLISH. Ambassador Shiner, in your testimony, you say that one of the areas the Administration is pressing to move forward with improving trade relations with China is in the enforcement of U.S. trade remedies. We have heard many statements today, and we are going to hear some more tomorrow of unfair and possibly illegal Chinese trade practices. You touched on this with Ms. Dunn, but clearly, there is some evidence of discriminatory tax policies like the VAT, dumping violations of IPRs, counterfeiting subsidies, monetary policy, and a plethora of technical barriers to trade. In your view, and can you be a little more specific in your testimony, which trade remedies in the U.S. trade remedy law arsenal would you think to be the most appropriate for the violations that we have listed here. Some of which I think are included in your testimony?

Ms. SHINER. I think as we look at the range of issues that you have addressed for example, on the VAT issues, we have been working with China on that. We have made clear our concerns about the discriminatory application of the VAT. Hopefully we will be able to bridge those differences. In every case, we hope to be able to work with them and we are actively engaged specifically on that. If not, we have the ability to bring cases in the WTO. We are committed to using the tools available to us. We have section 301, and we have got antidumping rules that we use.

Mr. ENGLISH. Within the range of options that the WTO provides us, would the Administration be open to considering a not necessarily China specific, but a strengthening of our trade laws in order to clarify some of those remedies and maybe make them more effective and more surgical?

Ms. SHINER. I don't know in the case of China and the cases you have raised that we don't feel that the tools would be available to address it. I think we feel that on them we have not yet come to the point where we are convinced we won't get the results that we want. In a number of the issues you raised in November, we will be taking an assessment, particularly on the VAT issue as to whether or not we are going to make progress.

So, I think we feel we have a range of tools available. We negotiated in some special tools in the accession package and we are looking at the areas that we have difficulty and continuing to press hopefully getting resolution. I will tell you that the high level engagements in China, I think, have really upgraded these issues across the board.

Mr. ENGLISH. Well, I thank you and I think it should be noted at this point that many of the tools that are in the accession package are the result of the efforts of Mr. Levin, and I don't believe he is here any longer, but I salute him.

Ms. SHINER. Yes, he is.

Mr. ENGLISH. Thank you.

Mr. CRANE. Mr. Foley.

Mr. FOLEY. Thank you very much, Mr. Chairman. In the U.S. General Accounting Office (GAO) report, it speaks almost specifically to the problem. The comprehensive scope and complexity of Chinese, WTO accession agreement presents two main challenges for successfully monitoring and enforcing China's compliance. First, the broad scope of the agreement which covers numerous aspects of China's trade regime and market access commitment for goods and service make it difficult to determine if each commitment has been fully implemented. I am sitting here with my phone and I see the battery is made in China. The phone's made in China. On July 4th they hand me a flag to wave made in China. You ask yourself a basic question. Are we afraid to enforce the basic tenets of some of these agreements with China? Now, specifically, I understand China's in violation of WTO commitments relating to protection of intellectual property. Their criminal law doesn't meet the standards laid out in the WTO Agreement on TRIPS. They haven't delivered on their promise in their protocol of the session to lower the criminal threshold for initiating private piracy cases and the prosecution rarely brings criminal prosecution. When is the USTR planning to initiate a trip dispute settlement case against China.

Ms. SHINER. Congressman, we are actively engaged with China on these issues. We do feel that if we can get results and again, we now not even 2 years into this accession process, but if we can get the results through those mechanisms that this will be the best methodology. If we bring a case it is not necessarily going to bring the kind of systemic changes we need to see now. So again, I think our current tactics are working with Vice Premier Wu Yi. We are getting attention at the top level and expect to see the enforcement and upgrading of their laws across the board.

I am going to spend 2 days in China on these issues in November. We do feel we are getting much higher level attention to it, and if our results are not sufficient, we will need to act in a stronger way. Again, even if we bring a case, we are going to continue—have to continue—with them to build in the kind of best practices and to get the kind of laws that will make this happen. So, we do feel that we have made progress in getting their attention on these issues. We do feel we are engaged we have done some capacity building with them. I feel it is important that we are getting involved with our neighbors in Asia to work with them on best practices. We take it very seriously. We understand the piracy rates. They have agreed to work with us on individual cases. We feel that they are putting attention we need on this, but if not, we will move where we need to.

Mr. FOLEY. I know Ms. Tubbs Jones mentioned some concerns, Ms. Dunn mentioned concerns and the American public is growing more impatient because they feel like by the time any of these agreements are truly enforced, our own manufacturers will be long gone. China does continue to impose heavy barriers to the import distribution of American films, music books, and other copyrighted goods and services.

For example, only state-owned companies may publish sound recording. Only a handful of Chinese companies designated by the government may distribute foreign films. Foreign programs are banned on prime time TV. Foreign investment is totally prohibited in some sectors and restricted to a minority share in others. It is impossible to win the fight against piracy unless a lot more legal product is allowed into the market. I know in Florida, not just the entertainment industry of which I am Chairman of the Entertainment Task Force, but also I am very concerned with citrus.

Every time we talk to them about citrus, they raise a red herring about phytosanitary. It seems like we are being constantly deluged with their goods, and then we are finding fire walls put up against ours. So, I want to be emphatic here, and I think my colleagues have been. I know the public is getting very leery of picking up every product in their grocery store or in their supermarket, their soft goods store and finding made in China. So, unless we are going to have a legitimate way in which to conduct an oversight of our activities with them, there is going to be horrific problems here domestically.

Ms. SHINER. Yes, and you know we have raised this at the highest level there. It has been raised across the board there. We will continue to do so. They are very clear at this point that if we do not see improvements, if we do not see improvement across the board systemically, I mean, traditionally in the past China has dealt with pressures in their trade relationships with big purchases or other things. What we have made clear to them is we need systemic across the board action.

China's not a startup, it is a turn-around. This is a country that is comprised of state-owned enterprises. They do not—they have not had these mechanisms in place. They have changed over a thousand laws and regulations in the past 2 years with the WTO accession. There is much more to be done and we have made it clear to them that despite the magnitude of the task, we are going to need to see results across the board in these areas or else we will have to move to stronger measures.

It was clear earlier this summer that the honeymoon was over as far as a waiting period for them to be able to enact all these. It is a massive task. There are, as you just pointed out, sweeping concerns across many areas. In a way China, because of their own success, is going to be held to a high standard very quickly. If they weren't exporting so much to the United States it wouldn't matter so much, but a lot is at stake. A lot is at stake in every single district here. They are very competitive, and so even though their task is massive, we are holding their feet to the fire and we need to.

So, I will tell you that I really do feel that the tone in our business community has changed since the summer. There was a feeling that it would take them a year to 18 months to get their act together on the accession commitments. The tone has changed. Our tone has changed also. We hear the urgency of it. I will tell you that they are under no misapprehension about the level of concern here in the United States and the task at hand. We presented to them very clearly the priority areas that need to be addressed. We are looking not only at concerns that are already in existence, but upcoming deadlines in their accession commitment that cannot be missed and making sure that those are on track also.

Mr. FOLEY. Mr. Chairman, would you indulge me for one more question?

Mr. CRANE. No. The time of the gentleman has expired, and I would like to yield to Mr. Becerra.

Mr. BECERRA. I thank the Chairman. I appreciate the testimony that we have received, and it is certainly difficult given international circumstances, to deal with countries. We can't govern in those countries. We can't change their laws. We can't ask them to be democratic, and so sometimes it is tough even with partners that do a great deal of trade with us and where they get a great deal of benefit from American money going to buy their products or American products helping them continue to build their own infrastructure.

So, I appreciate what the Administration does, what our trade representatives do, what all of our folks do and have done for ages to try to give America the best posture it can have when it comes to competitive trading. This is where, Ambassador Shiner, I have to say that when you mention you are trying to hold the Chinese's feet to the fire, quite honestly, I don't think you have to do that because I think the Chinese Government is doing that to its own people right now.

When they pay on average industrial northeast China, 60 cents an hour for their workers, we don't need to hold the feet over the fire because those feet are being held over the fire by those who are willing to pay people an average of 60 cents an hour.

That is about 2 percent of what we pay American workers in the manufacturing sector. So, what that tells us is that they get to work for 50 hours. They get to work one person for 50 hours to just meet the wage that we would pay for one worker working 1 hour. There is no way that we could ever compete with them on those terms. I don't care how many feet we hold over the fire in the Chinese Government, we are never going to be able to compete under those terms.

Perhaps that is why we have a trade deficit simply with China that is as we have indicated over $100 billion for this coming year. A total global deficit in trade of approaching $500 billion and no end in sight. Then we turn to the, what I believe are the effects, jobs in the manufacturing sector lost in this country, just in the last 3 years, California, my State, close to 300,000 jobs in manufacturing.

Illinois has lost close to 126,000 jobs in the last 3 years. Michigan, about 127,000 jobs in manufacturing. In New Jersey, 63,500 Americans left without a job in manufacturing. In North Carolina, 145,000 lost their job in the last 3 years. Ohio, close to 152,000 persons in Ohio have lost their jobs in the last years in manufacturing. Pennsylvania, more than 132,000 Americans have lost their jobs in manufacturing. Wisconsin, more than 73,000 Americans have lost their jobs in manufacturing in the last 3 years. With this economic recovery coming in, and perhaps it is there and I know that Mr.—I think it is Dr. Mankiw who mentioned that was on its way.

Let me ask this question: do you believe that these States, the Americans in these States that I have mentioned who have lost their jobs, will recoup these lost manufacturing jobs any time soon? If so, when?

Dr. MANKIW. I do believe the economy is recovering, and you are absolutely right that manufacturing has been hit particularly hard in this business cycle. The reasons for that——

Mr. BECERRA. Doctor, let me say, I have a—the hundreds of thousands of folks that I just mentioned, the millions, the 2.5 million who have lost their manufacturing job in the last 3 years can't ask this question and we have 5 minutes to ask questions. So, my question to you is if you could talk to those 2.5 million Americans who in the last 3 years in this country have lost their jobs in manufacturing, can you tell us will they recoup their jobs, and if so, when?

Dr. MANKIW. I think some of them will recoup the same jobs. Some of them will recoup other jobs. I think we will see job growth soon. I think the data that we saw today was extremely promising, and the GDP growth is also a leading indicator of job growth. I think we will see a robust job growth going forward.

Mr. BECERRA. Now this is the growth that showed the budget deficit was $80 billion less than we had anticipated which is good news. So, we are obviously seeing more economic activity. That is the good news. The bad news of course is that even though the budget deficit is $80 billion less than we thought it would be for the fiscal year, it is still going to be a record $470 billion in deficit, the largest deficit we have seen in the history of this country. So, while it is pretty good news that it is not an additional $80 billion on top of that, we still have problems.

In fact, unless things have changed, my understanding is that next year we are projecting a budget deficit of close to $500 billion in this country, which really straps us in what we can try to do to try to encourage the growth of manufacturing jobs in this country. So, I guess my appeal to you is that as I said at the very beginning, we are somewhat tied in.

Mr. Chairman, I will close with this final remark if I may. I know we are kind of strapped, and I appreciate what you do. I think everyone would acknowledge that everyone, whatever the Administration stripe is, you fight for American jobs where you can, but please use the tools that you have. You mentioned you have tools. Use them. I think the Chinese will learn. They know how to negotiate. Let them learn, but let's use our tools. I thank you very much for all you have done.

Mr. CRANE. Yes. All right. What I would like to do—you have got just one quickie question, do you, Mr. Pomeroy? All right. You go forward with yours quickly.

Mr. POMEROY. Ambassador Shiner, I would just remind you that in my view, the WTO, the favored trading status of China would not have passed Congress but for the support of rural Members. So, we are very eager for aggressive oversight by the USTR to make certain China is complying with their WTO commitments especially relative to agriculture and our exports there. I also have recently learned of the case of, as we wrestle with are they embracing rule of law as conventionally understood in our country and in our Congress, I have been told of the case of Yang Long, a Chinese entrepreneur whose automotive company, Brilliance China, was allegedly seized by the Governor of a Chinese province without compensating the owner. This is very in consistent with the—what we are hearing in a more broadly stated efforts of the economic reform underway in China. I understand it is working on a draft law to address abuse by government entities when they are market participants. I would certainly hope that the USTR and other U.S. agencies talking to China will encourage them to get on top of this situation if they want to encourage investment as well as let their own entrepreneurs flourish.

Mr. CRANE. Mr. Tanner.

Mr. TANNER. Thank you very much, Mr. Chairman. I will be brief. I want to submit some questions for the record, if I might.

Mr. CRANE. Without objection so ordered.

Mr. TANNER. One of the matters that troubles me greatly is our deteriorating financial situation and the amount of money we are borrowing. China has increased their purchase of our debt 78 percent, and along with Hong Kong, now owns almost $200 billion worth of our debt. The Japanese own almost $500 billion of our debt. There was a really, I thought, astonishing quote by Joan Zing, a formal official at the Peoples Bank of China, who said the U.S. dollar is now at the mercy of Asian governments. If China wants to influence the market, it can. That may be an overstatement. It may not. I think we are getting into real trouble, and I would like to ask you to comment on it briefly.

I have got some other questions that I will submit for the record, but it doesn't take a rocket scientist to realize that if they have a large amount of our debt maturing in a relatively brief period of time, there would be some influence or some leverage that could be exercised that might adversely affect a decision our government might otherwise want to make with regard to a particular issue in the future.

Mr. TAYLOR. Congressman, we have a broad deep liquid securities market in Treasury securities in the United States. It is an attractive vehicle for many, many people around the world and in the United States to invest in. We are confident of this market at this point in time; do not see or have heard of the concerns that you are raising. I would emphasize so much that the market is working fine. It is resilient. It is deep, and we will continue to make it that way.

Mr. TANNER. I understand that, but it is not limitless, and if you haven't heard of it, it has been in the London Financial Times and also other financial papers around. I will be glad to share with you what I have read about it.

[Letter submitted from Mr. Tanner to Secretary of the U.S. Department of the Treasury, and Mr. Taylor's response follows:]

November 7, 2003

The Honorable John W. Snow
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20420

Dear Mr. Secretary,

I am writing regarding testimony given by John Taylor, Under Secretary for International Affairs at the U.S. Department of the Treasury, during the recent House Ways and Means Committee hearing on the United States-China Economic Relations and China's Role in the Global Economy. Due to time constraints and a very busy voting schedule, I did not have time to fully question the witness representing your agency.

During the hearing, I inquired about the increase in Chinese holdings of United States debt. As you know, Chinese holdings (including Hong Kong) of U.S. debt have increased from approximately $100 billion to $178 billion in only 3 years. I also understand the securities purchased by the Chinese mature in a year or less. Since the Chinese Central Bank controls such a large volume of U.S. debt, their ability to affect our economy seems very real. I think this poses a national security threat, because our relationship with Beijing is inconsistent at best. Should a diplomatic crisis occur, the Chinese government could choose to sell its large share of U.S. securities on the open market, and we would be forced to increase interest rates in an attempt to attract other purchasers. I don't need to tell you how damaging that action would be for our economy.

Therefore, during the hearing I asked Mr. Taylor what assurance the Treasury Department could give us that our economy is not susceptible to being held hostage by the Chinese government. Mr. Taylor responded by informing me that the U.S. debt market is sufficiently wide and deep to handle the demand if the Chinese sold its U.S. debt. Given the time limitation we had during the hearing and the brevity of his response, I would like to request a more detailed answer to this question.

In addition to the aforementioned question, I did not have time to seek information on another topic. In 2002, outlays by foreign direct investors in the United States fell by more than half for the second consecutive year. Foreign direct investment in the U.S. fell from $314 billion in 2000 to $30 billion in 2002. Last year, foreign investment in the United States was less than what was invested in France and Germany. As a result of this decline, spending for new investments in 2002 was at the lowest level in decades. Furthermore, China has replaced the United States as the largest recipient of foreign direct investment. Increasingly, foreign companies and individuals have not been willing to make permanent investments in the U.S. economy, choosing instead to invest in China and other countries. Therefore, I am requesting information on the Administration's plan to increase direct foreign investment in the United States and reduce foreign central bank purchases of U.S. debt?

I appreciate the Treasury Department's willingness to testify before the Committee and look forward to your response to my questions.

Sincerely,

John S. Tanner
Member of Congress

December 17, 2003

The Honorable John Tanner
U.S. House of Representatives
Washington, D.C. 20515–4208

Dear Mr. Tanner:

I am replying to your letter to Secretary Snow, which followed up on your question to me during my recent testimony on United States-China economic relations before the House Ways and Means Committee. Your letter expressed concern that the Chinese government, holding a large volume of U.S. debt, could adversely affect the U.S. economy and requested information on how the Administration planned to increase foreign direct investment in the United States and to reduce foreign central bank purchases of U.S. debt.

It is important to restate, as I did at the hearing, that the United States has a broad, deep and liquid market in Treasury securities. Treasury securities are an attractive vehicle in which many people from around the world and in the United States invest. We are confident of this market and do not view the possibilities that you raise as sources of major concern. Chinese holdings of U.S. Treasury securities are a small part of the over $3 trillion in public debt securities held outside Federal Reserve and U.S. government accounts, and total public debt held outside these accounts amounts to only about 15 percent of the domestic nonfinancial credit market.

As to your question on foreign direct investment, many factors influence foreign investors' decisions about whether to invest in the United States in the form of portfolio or direct investment. Foreign direct investment to the United States rose dramatically over the last decade, from $20 billion in 1992 to a peak of $321 billion in 2000. It then declined to $152 billion in 2001 and $40 billion in 2002. It has, however, strengthened in the first three quarters of this year to reach $87 billion at an annual rate. The recent drop in inward direct investment coincided with the slowdown in economic activity in the United States and overseas. More specifically, the decrease in direct investment in 2002 appears to have reflected financial restructuring and write-downs of investments in the wake of the boom in foreign investors' U.S. acquisitions between 1998 and 2000, reduced financing requirements by U.S. affiliates from their foreign parents, and a sharp slowdown in new acquisitions by foreign parents.

Although direct investment into the United States eased during the slowdown, other forms of private foreign investment were robust. Strong economic fundamentals and an attractive investment environment continue to draw foreign investment to the United States. Decisions on the precise form that foreign investment in the United States should take are usually best left to the marketplace.

We appreciate hearing your concerns.

Sincerely,

John B. Taylor
Under Secretary for International Affairs

Mr. CRANE. I thank you, and I want to express appreciation to our panel for your patience. We apologize to you for running late like this. With that, this panel may be excused, and we will recess subject to the call of the Chair.

[Recess.]

[Questions submitted from Mr. Neal to Mr. Taylor, and his response follows:]

Question: There are a growing number of reliable reports indicating that the Chinese currency, the Yuan, is undervalued by 15% to 40%. These reports include the statutory "2004 report" by the Department of the Treasury, released last Thursday, October 30. However, the Treasury Report stops short of noting the correlation between China's currency manipulation and harm, including massive manufacturing job losses, to the U.S. economy as a result.

Does Treasury not share the widely held view that China has a substantially undervalued currency, giving it an unfair price advantage of between 15% and 40% over U.S. products and services, in turn making the trade deficit worse and harming U.S. manufacturers and workers? If so, why doesn't the Administration support legislation introduced in this House and in the Senate that would press China to end its currency manipulation? In the alternative, what specific actions beyond "technical assistance" is the Administration prepared to take to address this serious problem? In particular, does the Administration support using WTO rules as appropriate to press China and certain other trading partners to end their currency manipulation practices and become fair players in the global trading system?

Answer: It is difficult to say what the level of any particular exchange rate should be, but we feel strongly that exchange rates should be market determined. We share your concerns and are intensifying our interactions with Chinese officials to ensure that they introduce significant flexibility in their exchange rate regime. In various recent meetings, Chinese officials have agreed that they need to make this change. They point to weaknesses in their financial system to justify an additional adjustment period, but we are taking a number of steps to accelerate their resolution of the situation.

In particular, the first of a series of Technical Cooperation Program teams will travel to China in late February. The Treasury Department and other U.S. Government agency specialists will work directly with China's central bank on a range of topics linked to exchange rate flexibility.

Secretary Snow has also engaged directly the number-two official in China's cabinet, Vice Premier Huang, who supervises financial and exchange rate matters. Secretary Snow met with Huang in Beijing last year, and Huang has accepted Secretary Snow's invitation to come to Washington soon to continue action-oriented discussions.

Finally, within a month or two at the latest—once necessary background checks are completed—Secretary Snow will announce the appointment of a new Senior Treasury Attaché in Beijing to be his personal emissary to top Chinese leaders on this subject.

We feel that this diplomatic approach is the one most likely to succeed, and President Bush has made clear also that we intend to press China to meet all of its WTO commitments. We appreciate your interest and support in this effort.

Mr. CRANE. [Presiding.] We don't have all of our colleagues back here yet, but we will try to get started to accommodate you folks, and we appreciate your patience in sticking it out. We will proceed in order. So, Dr. Holtz-Eakin, you can proceed first, followed by Dr. Yager and then Dr. Rogowsky.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. HOLTZ-EAKIN. Mr. Chairman, thank you, and Members of the Committee. The Congressional Budget Office (CBO) appreciates the chance to join in the discussion today. You have our written testimony submitted for the record. It is fairly long and quite detailed. I will not pretend at this late hour to go through all the details of the testimony, but will be happy to answer questions as the time arises.

Let me instead merely point out some of the key bottom lines that the testimony wishes to make. If you look at the current setting, three broad facts stand out as items of interest. The first is that the Chinese have pegged their currency at 8.28 yuan to the dollar for nearly a decade, even during periods of the Asian financial crisis, when other countries depreciated their currency relative to the yuan. At the same time, the United States is running a roughly $100 billion bilateral trade deficit with China. While that is only 20 percent of the overall U.S. current-account deficit, it is a deficit that has risen rapidly in the past several years, and we have seen a decline of 2.8 million jobs in the manufacturing sector.

There is a temptation by many to draw a causal linkage from the currency to the bilateral trade deficit to the U.S. manufacturing jobs picture. Indeed, there are pieces of legislation before both the House and the Senate at this time that would appear to suggest this causal link and that go further and offer up a policy alternative, which is to use the prospect of some sort of trade sanctions—perhaps, a tariff—against China's imports as a lever to have either a free float or revaluation of the Chinese currency.

The bottom line, after walking through both the empirical foundation of that kind of a linkage and an analysis of those policy options, is that, first, it is very difficult to make an empirical case that trade per se or trade with China in particular can be identified as the source of a large quantitative job loss in U.S. manufacturing. I can return to the details of that as the Committee sees fit.

Second, the efficacy of the policies that have been mentioned in some of the legislation really depend on the kinds of goals that the Congress might have in mind. For example, to the extent that the goal is to raise manufacturing employment in the United States, these types of policies would have small effects at best and would be temporary. If, instead, the primary objective would be to reduce the bilateral trade deficit with China, there would be the possibility that that bilateral trade deficit would be reduced; however, it would come at the expense of a larger trade deficit with other trading partners. In general, if the objective is to lower the U.S. multilateral trade deficit, the bilateral currency valuation between the

United States and China plays a very small role in the overall determination of the current-account deficit, and for that reason, it would have a small effect at best.

Third, it may be the case that revaluing the Chinese currency would affect China's overall current-account balance. It is close to balance now, but China is running a sustained capital-account surplus, and it may be the case that a revaluation would be the beginning step toward what I think is a general consensus of the desirability and likelihood that China will have a more flexible exchange rate policy in the long run and will move toward more open capital markets at the same time.

So, with those highlights, let me close there and thank the Committee for the chance to be here. I look forward to answering your questions.

[The prepared statement of Dr. Holtz-Eakin follows:]

Statement of Douglas Holtz-Eakin, Ph.D., Director, Congressional Budget Office

Mr. Chairman and Members of the Committee, thank you for inviting me to testify on the relationship among patterns in manufacturing employment; U.S. trade with China; the exchange value of China's currency, the Yuan; and legislative proposals linking increases in the Yuan's value with potential trade sanctions by the United States.

The Perceived Problem and the Proposed Legislation

Since 1994, China has maintained a fixed rate of exchange of 8.28 between the Yuan and the U.S. dollar. Today, the United States' bilateral trade deficit with China is the largest deficit that this nation has with any single trading partner, and U.S. manufacturing employment has registered a decline of 2.8 million jobs since July 2000. Some observers believe that China's exchange rate policy artificially holds down the value of the Yuan to the detriment of U.S. manufacturing output and employment in both import-competing and exporting industries. They contend that allowing or forcing the Yuan to appreciate relative to the dollar will have a notable and positive effect on manufacturing output and employment in the United States.

Recent legislative proposals reflect that line of reasoning. H.R. 3058 and S. 1586 would require increased tariffs or another form of barrier against Chinese imports if China did not agree either to allow the Yuan to float on foreign currency markets or to revalue it relative to the dollar. The specific impact of any such measure would depend on the magnitude of the exchange rate change or tariff. Nevertheless, the Congressional Budget Office (CBO) has reached the following general conclusions regarding the prospects for any such legislation's achieving the goals outlined below:

- *Increasing U.S. Manufacturing Employment.* At best, such legislation would increase employment in manufacturing by a small amount and for a limited period. It would not have a significant permanent effect.
- *Reducing the U.S. Bilateral Trade Deficit with China.* Such legislation might somewhat diminish the trade deficit with China but at the expense of increases in the United States' bilateral deficits with other countries.
- *Reducing the Chinese Multilateral Trade Surplus.* Such legislation could shrink China's multilateral trade surplus (its surplus with all trading partners).
- *Reducing the U.S. Multilateral Trade Deficit.* Such legislation could reduce the multilateral trade deficit of the United States by at most a small amount and, depending on the circumstances (in particular, if the legislation was paired with corresponding measures by China against U.S. exports), might even increase that deficit by a small amount.

Before I turn to CBO's analysis of the specific impacts of the proposed measures, it is useful to discuss the context of recent economic developments in the United States and China.

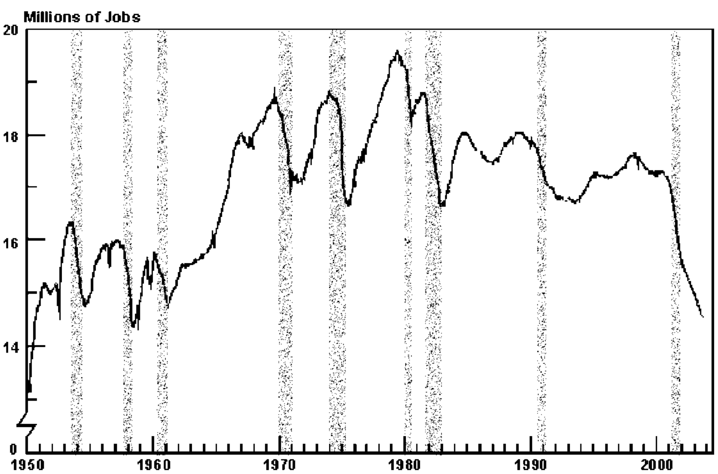
U.S. Manufacturing

Employment in the manufacturing sector of the U.S. economy stood at 14.6 million jobs in September 2003, its lowest level since October 1958 and down from 17.4

million in July 2000 (*see Figure 1*). Much of the decline is probably temporary and related to the recent recession and the relatively weak recovery in demand since the recession's end in November 2001. Some of that decline, however, reflects a long-term downward trend in manufacturing employment. The past three years of recession and moderate recovery were particularly hard on employment in manufacturing, as the demand for manufactured goods remained weak in both the United States and the rest of the world and as virtually all of the moderate upturn in demand since the trough of the recession was met by extraordinary gains in productivity rather than by increases in the number of jobs or work-hours. Because changes in employment are dominated by those large cyclical, as well as trend, changes, any effect that trade with China has had on U.S. manufacturing employment is more likely to be apparent by examining more-detailed industry-level data.

Figure 1.

Manufacturing Employment



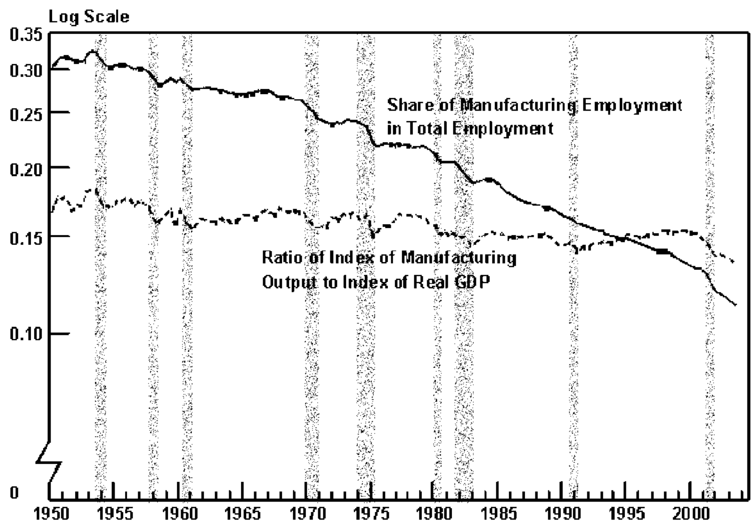
Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: Shaded areas denote recessions as defined by the National Bureau of Economic Research.

Long-Term Influences

The long-term decline in U.S. manufacturing employment largely reflects the strong trend growth of productivity in the manufacturing sector and a pattern in consumption spending away from goods and toward services. Currently, a worker in manufacturing produces more than he or she did ten, or even five, years ago, largely because manufacturers have invested in more and better capital goods. Also, as the U.S. and other economies have become richer, households are allocating a smaller fraction of their consumption to goods, causing a downward trend in the goods share of GDP. Those long-term influences suggest that employment in the manufacturing sector may not return to prerecession levels even after the economy has fully recovered from the 2001 downturn. Indeed, the share of total employment in the manufacturing sector has trended down strongly for the past 50 years, whereas the rate of growth of manufacturing output has been only slightly slower than that of real (inflation-adjusted) gross domestic product, or GDP (*see Figure 2*).

Figure 2.
Manufacturing Output and Employment

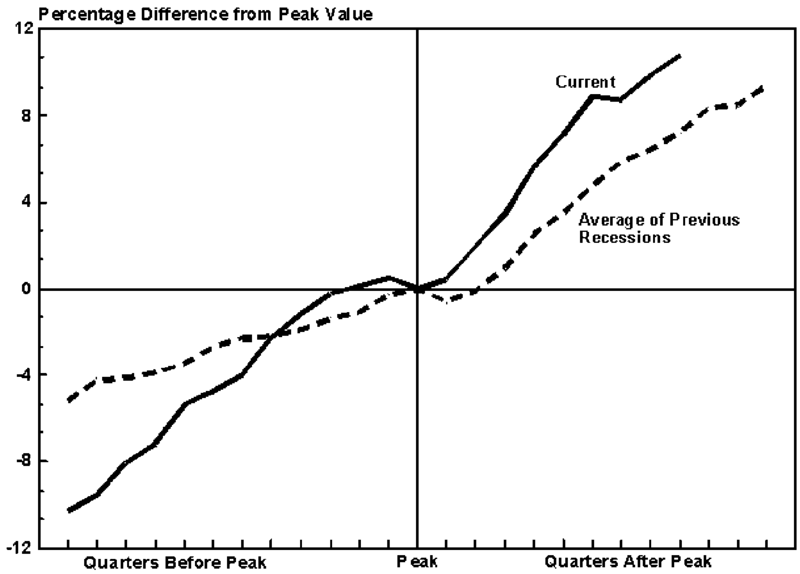


Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Department of Commerce, Bureau of Economic Analysis.
Note: Shaded areas denote recessions as defined by the National Bureau of Economic Research.

Productivity. The long-term growth of productivity, driven by investment and new technology, has allowed manufacturers over at least the past 50 years to match the pace of overall economic growth without corresponding growth in employment. That trend continues today: labor productivity in manufacturing (output per hour worked in manufacturing) has grown at a surprisingly rapid pace during the past several years.

Since the peak of the last business cycle in March 2001, labor productivity in manufacturing has risen at an average annual rate of 4.0 percent, faster than its average annual rate of growth during previous postwar recessions and the early part of the ensuing recoveries (*see Figure 3*). That rapid productivity growth has allowed manufacturers to meet the recent weak demand for their goods with a smaller workforce working fewer hours than would have been required if productivity had grown more slowly.

Figure 3.
Cyclical Behavior of Labor Productivity in Manufacturing



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: The peak is the end of a business-cycle expansion as defined by the National Bureau of Economic Research.

Shifts in Demand. Further contributing to the long-term decline in manufacturing employment has been the shift in demand by consumers toward services and away from manufactured goods. As real income has risen over time, the demand for services has increased by more than the demand for goods. For example, in 2000, 42 percent of consumer spending was devoted to goods, down from 53 percent in 1979 and 67 percent in 1950.

The Recession of 2001 and Its Aftermath

The recession and its aftermath have hit the manufacturing sector hard. Declines in employment are normal during recessions, but the fact that employment has continued to fall as much as it has since the recession's official end is unique to this downturn.

Employment in manufacturing through September 2003 has declined for 38 consecutive months, with the most recent monthly increase posted in July 2000. The magnitude of job losses in the recent recession and recovery is comparable to that surrounding the back-to-back recessions in 1980 and 1981 to 1982. Indeed, employment has fallen by 16 percent since its peak in the second quarter of 2000, compared with losses averaging 10.2 percent during and surrounding four previous periods of recession.[1] More than half of the losses since the peak in employment have occurred in five industries: computer and electronic products, transportation equipment, machinery, fabricated metals, and apparel. At the same time, however, employment has declined in all 21 industries that make up the three-digit level of manufacturing industries in the North American Industrial Classification System

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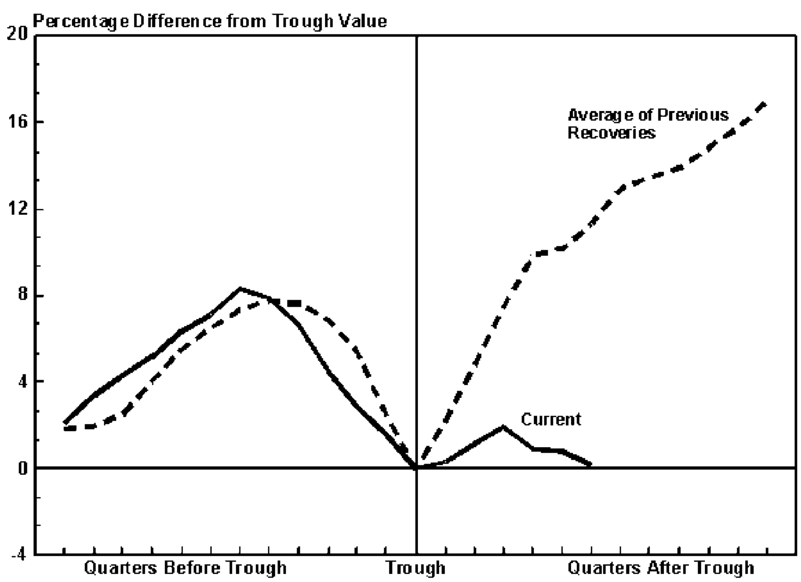
[1] Those periods of recession are as follows (with "Q" used to mean "quarter"): 1969Q3 to 1971Q3, 1973Q4 to 1975Q2, 1979Q2 to 1983Q1 (which treats the 1980 and 1981–1982 recessions as a single episode), and 1989Q1 to 1992Q4. Note that those dates are defined in terms of manufacturing output and employment and do not strictly correspond to recessions as designated by the National Bureau of Economic Research, which maintains the official chronology of U.S. business cycles.

(NAICS), and 15 of the 21 have experienced losses exceeding 10 percent. In fact, all 21 industries have shown declines even since November 2001.[2]

The drop in manufacturing employment since the beginning of the recession largely reflects the weak demand for manufactured goods both in the United States and among its major trading partners. The demand for capital goods remained stagnant in the years following the investment surge of the late 1990s. As a consequence, manufacturing output fell sharply during the recession, and it has grown more slowly in the quarters since the recession ended than it did on average after previous downturns (*see Figure 4*). The weak demand for U.S. manufactured goods among the nation's major trading partners reflects the tepid pace of their economies' growth. In the past few years, foreign GDP has grown only about as fast as U.S. GDP (*see Figure 5*). By contrast, during past U.S. recessions and the early part of recoveries, foreign economic growth generally was faster than that of the United States, supporting U.S. exports. As shown in Figure 6, U.S. exports have been weaker during the 2001 recession and the recovery thus far than in most previous recessions. The figure also indicates that imports have grown about as fast as they typically have after previous recessions, suggesting that the recent increase in the U.S. trade deficit is due more to weak growth of exports than to strong growth of imports.

Figure 4.

Cyclical Behavior of Manufacturing Output

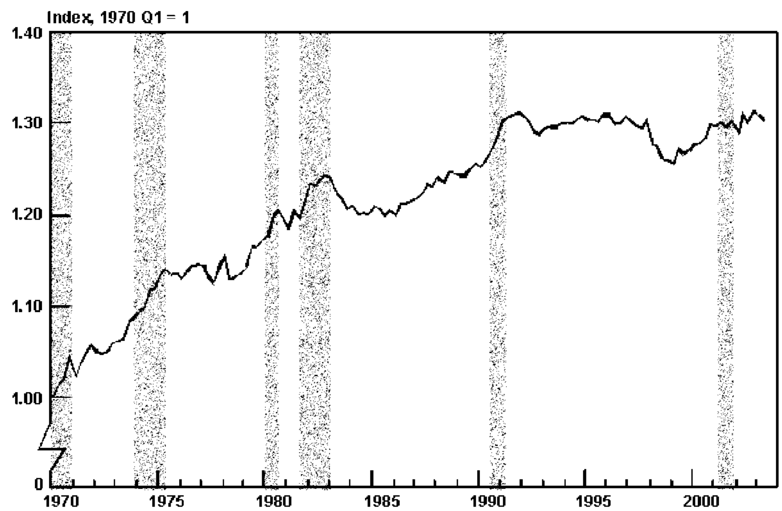


Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: The trough is the end of a recession as defined by the National Bureau of Economic Research.

[2] NAICS is a newly introduced system of classifying industries, created jointly by the United States, Canada, and Mexico. All establishments are classified on the basis of the production process they use, in contrast to the previous Standard Industrial Classification, or SIC, system, in which some establishments were classified by using different criteria (such as class of customer).

Figure 5.
Ratio of Foreign to U.S. Real GDP

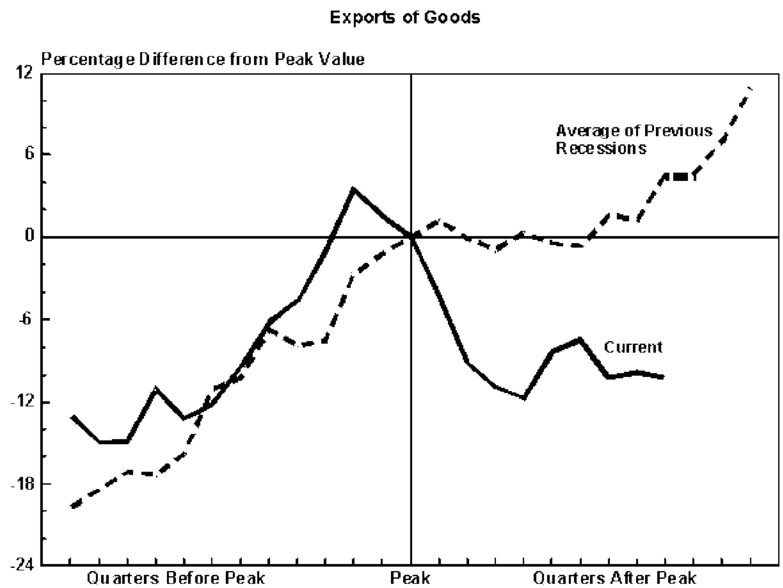


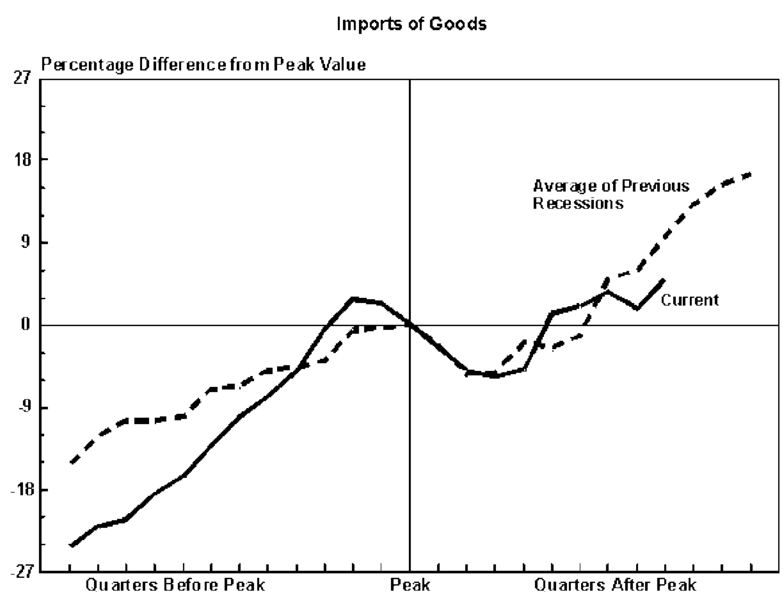
Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Research.

Notes: Foreign gross domestic product (GDP) is the export-weighted GDP of Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, Italy, Japan, Mexico, the Netherlands, Singapore, South Korea, Taiwan, and the United Kingdom.

Shaded areas denote recessions as defined by the National Bureau of Economic Research.

Figure 6.
U.S. Exports and Imports



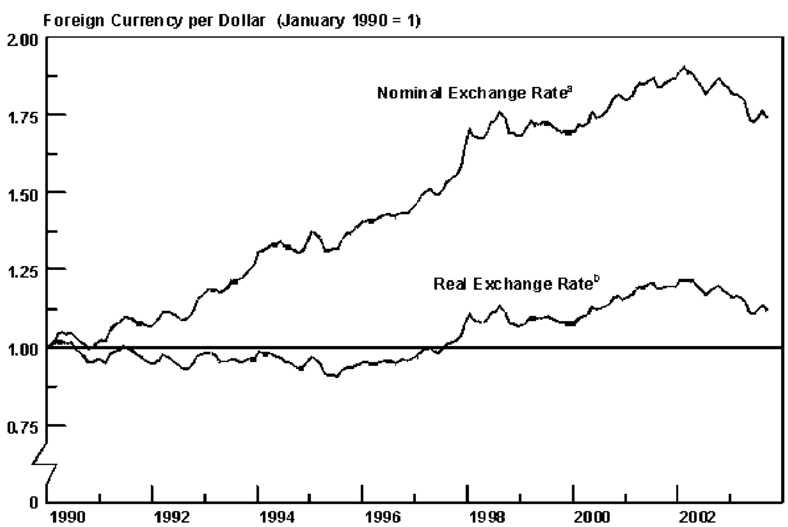


Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

The United States' relatively lackluster export performance has probably also been influenced by the strength of the U.S. dollar. An increase in the value of the dollar raises the price of U.S. exports for foreigners and lowers the dollar price of U.S. imports. In the absence of other influences, those price changes tend to increase the U.S. trade deficit. The dollar appreciated in both nominal and real terms against most currencies between 1990 and early 2001, and although it has weakened recently, it is still strong relative to its value in virtually all of the 1990s (*see Figure 7*).

Figure 7.

U.S. Dollar Exchange Rate



Sources: Congressional Budget Office; Federal Reserve Board.
a. The nominal exchange rate is a trade-weighted exchange value of the U.S. dollar against 35 foreign currencies.
b. The real exchange rate is the nominal exchange rate multiplied by the U.S. price level relative to the trade-weighted foreign price level.

Employment in the manufacturing sector is likely to pick up substantially once the demand for manufactured goods recovers from its recent slump. Nevertheless, the trend of long-term decline suggests that the level of employment is not likely to return to its postwar high of the late 1970s or possibly even to its prerecession level.

Measurement Issues

The long-term decline in manufacturing employment is also due in part to a structural shift in the organization of work: manufacturers have increasingly hired temporary workers and outsourced tasks to domestic nonmanufacturing firms that had previously been performed by manufacturing employees. Between 1990 (the first year for which data consistent with the current definition of the industry are available) and 2000, employment at temporary-help services more than doubled (from 1.2 million jobs to 2.6 million), although it fell sharply during the recession. Similarly, historical data that are not strictly comparable with the current data nevertheless suggest that the number of temporary workers had at least doubled during the 1980s as well.

Typically, about 30 percent of temporary workers were working at manufacturing establishments during the 1990s, according to results from periodic special supplements to the Current Population Survey. However, for statistical purposes, they were treated as being employed by the temporary-help services industry. An implication of that finding is that a large part of the decline in manufacturing employment during the 1990s, as well as a portion of the decline during the 1980s, might be attributable to the increasing use of temporary workers. In addition, manufacturers today are increasingly contracting with outside firms to provide certain support functions (for example, cafeteria and janitorial services and payroll processing) instead of providing them internally; that, too, has tended to depress measured employment attributable to manufacturing. However, data are not available to determine how much (if any) of the decline in manufacturing jobs since 2000 can be ascribed to those phenomena.

How Imports from China May Be Affecting Particular Industries

In 2002, imported goods from China accounted for 10.8 percent of the value of all U.S. imports of goods, up from 7.8 percent in 1998. Of the increase in the value of all such imports over that period, 22 percent is attributable to goods from China. To assess the possible impact on U.S. manufacturing employment of increased imports from China, CBO examined patterns of employment in detail, looking at manufacturing industries covered under the four-digit NAICS codes. CBO focused on the performance of 25 such industries from 1998 through 2000 in which Chinese imports were 10 percent of the value of total imports and China either accounted for half of the increase in the value of imports or increased its imports to the United States in cases in which total industry imports fell.[3] In 2000, those industries together employed 5.5 million workers, or roughly 32 percent of overall manufacturing employment. Between 2000 and 2002 (based on full-year averages), employment in those industries fell by 13.8 percent, or 753,000 jobs. By comparison, employment in all other manufacturing industries fell by 10.2 percent over that period.

The decline in employment for all other manufacturing industries could be interpreted as a rough indicator of conditions common to the entire manufacturing sector, independent of the impact of trade with China. Under that assumption, the additional 3.6 percentage-point decline could plausibly be attributable to expanding trade with China. That decline translates into a loss of about 200,000 manufacturing jobs, or 10 percent of the total job loss in manufacturing between 2000 and 2002. However, the industries that CBO assessed performed somewhat better than the rest of manufacturing between 1998 and 2000. Thus, if changes in employment over the full four-year period from 1998 to 2002 are considered, only about 90,000 additional lost manufacturing jobs can be attributed to imports from China.

Those estimates might be too high or too low, for a number of reasons. On the one hand, the overall impact on manufacturing employment might be as much as twice the direct effect once one accounted for the lost income and concomitant reduction in spending. On the other hand, nearly half of the excess manufacturing employment losses derived from this exercise were in firms producing semiconductors, an industry that has experienced rapid productivity growth and depressed demand. The calculations also assumed that all of the increase in imports from China came exclusively at the expense of domestic producers and were not displacing imports from other countries. Finally, although increased imports (from all trading partners) will in many instances result in identifiable job losses, any effect on overall employment, as noted earlier, will be temporary.

One industry that has experienced especially large employment losses in the past several years is information technology (IT). Since early 2001, employment in firms making computers and electronic products has shrunk by 470,000 jobs, or roughly a quarter. Much of that decline can be traced to the large boom and subsequent decline in the late 1990s in businesses' investment in computers and telecommunications equipment. But it also appears that some U.S. production has been displaced by overseas competitors, including China, in recent years.[4] In 2002, the U.S. trade deficit in IT products (defined as computer, electronic, and communications equipment; consumer audio and visual equipment; and medical and other instruments) increased by $17 billion. Of that amount, $7.2 billion could be attributed to the change in trade flows with China.

That shift reflects several factors. One factor tending to increase the United States' trade deficit with China is China's "expanding role as a center for low-cost manufacturing and assembly of standardized IT products."[5] Another factor is the particular pattern of demand for IT goods over the past several years. China tends

[3] The four largest industries meeting those criteria were semiconductors and other electronic components; miscellaneous manufactured commodities; printing, publishing, and similar products; and household and institutional furnishings and kitchen cabinets.

[4] Rob Valletta, "Is Our IT Manufacturing Edge Drifting Overseas?" *Federal Reserve Bank of San Francisco Economic Letter,* No. 2003–30 (October 10, 2003).

[5] Ibid.

to specialize in exports of IT consumer goods, for which demand has remained strong, whereas U.S. production and exports focus much more on IT products for businesses, for which recent demand has been quite weak. A factor tending to lower the trade deficit with China is that IT producers in the United States have substantially increased exports of intermediate products (such as microprocessors) to China. As a result, it is difficult to quantify how much of the IT sector's decline in employment over the past several years is directly related to trade. However, the specific effect is probably small relative to the impact of the slump in businesses' investment spending and of continuing advances in productivity.

Patterns of International Trade

U.S. imports from China and the bilateral U.S. trade deficit with China have grown rapidly over the past decade. However, the vast bulk of that growth in imports has displaced imports from other countries rather than U.S. domestic production. The primary force driving the increase in imports from China is that manufacturers have shifted the final assembly of many of their products from other Asian (and perhaps a few non-Asian) countries to China. Much of the value of Chinese exports continues to consist of parts made elsewhere in Asia. In short, the United States' bilateral trade deficit with China represents the net balance of trade with many Asian countries that is channeled primarily through China.

U.S.-Chinese Bilateral Trade

With the growth of U.S. exports to and U.S. imports from China over the past decade, China has become one of the United States' most important trading partners. Significant U.S. exports to China include airplanes, electronic components and equipment, and agricultural products and chemicals. Significant imports include electronic equipment, toys, footwear, and apparel. The United States' trade deficit with China has also grown rapidly and is now the largest bilateral deficit that the United States has with any country.

U.S. Exports to China. Between 1992 and 2002, U.S. exports to China increased from $7.5 billion to $22.1 billion, an average annual rate of growth of 11.4 percent. More recently, that rate has accelerated, averaging 16.5 percent between 2000 and 2002. That rapid growth has raised China from the tenth largest U.S. export market in 1997 to the sixth largest in 2002. Thus far in 2003, China is surpassing South Korea to become the United States' fifth largest export market (*see Table 1*).

Table 1. The Largest Markets for U.S. Exports

Country or Region	**U.S. Exports in 2002 in Billions of Dollars**	**U.S. Exports from January to July 2003 in Billions of Dollars**	**U.S. Exports in 2002 as a Percentage of Total Exports**
Canada	160.8	97.8	23.2
European Union	143.7	87.1	20.7
Mexico	97.5	54.5	14.1
Japan	51.4	30.2	7.4
South Korea	22.6	13.9	3.3
China	**22.1**	**14.8**	**3.2**
Taiwan	18.4	9.4	2.7
Singapore	16.2	9.5	2.3
Australia	13.1	7.5	1.9
Hong Kong	12.6	7.4	1.8
Brazil	12.4	6.2	1.8
Malaysia	10.3	6.0	1.5

Table 1. The Largest Markets for U.S. Exports—Continued

Country or Region	U.S. Exports in 2002 in Billions of Dollars	U.S. Exports from January to July 2003 in Billions of Dollars	U.S. Exports in 2002 as a Percentage of Total Exports
Switzerland	7.8	5.0	1.1
Philippines	7.3	4.7	1.0
Israel	7.0	4.0	1.0
Memorandum:			
All Countries and Regions	693.3	411.1	100.0

Source: Congressional Budget Office based on data from the Bureau of the Census.
Note: Numbers given are free-alongside-ship values of total exports.

Although exports to China have grown rapidly on a percentage basis, that growth was from a small base. What matters more from the standpoint of demand for U.S. products and jobs in the U.S. export sector is the overall dollar value of the growth of those exports. By that measure, China ranked fourth among markets that increased their demand for U.S. exports from 1992 through 2002 and third from 1997 through 2002 (well behind Mexico and a bit behind Canada). Thus, even with its rapid growth, China is a substantially smaller market than Mexico is—less than one-fourth its size—and is not likely to become comparable in the near future.

The largest categories of exports by value in 2002 were airplanes, semiconductors and electronic components, electronic equipment (such as computers and navigational and medical instruments), soybeans, and various fertilizers and chemicals (*see Table 2*).

Table 2. The Largest Categories of U.S. Exports to China in 2002

Product Category[a]	In Billions of Dollars	As a Percentage of All U.S. Exports to China
Aerospace Products and Parts	3.6	16.4
Semiconductors and Other Electronic Components	2.2	9.8
Waste and Scrap	1.2	5.5
Computer Equipment	1.2	5.3
Navigational, Measuring, Electromedical, and Control Instruments	1.0	4.6
Soybeans	0.9	4.0
Resin and Synthetic Rubbers	0.8	3.4
Fertilizers	0.7	3.0
Other General-Purpose Machinery	0.6	2.7
Other Basic Organic Chemicals	0.6	2.7
Meat Products and Meat-Packaging Products	0.6	2.5

Table 2. The Largest Categories of U.S. Exports to China in 2002—Continued

Product Category[a]	In Billions of Dollars	**As a Percentage of All U.S. Exports to China**
Telephone Apparatus	0.5	2.2
Other Industrial Machinery	0.5	2.1
Ventilation, Heating, Air-Conditioning, and Commercial Refrigeration Equipment	0.4	1.6
Paper Mill Products	0.3	1.5
Metalworking Machinery	0.3	1.4
Special Classification Provisions	0.3	1.4
Mining and Oil and Gas Field Machinery	0.2	1.1
Commercial and Service-Industry Machinery	0.2	1.1
Pulp Mill Products	0.2	0.9
Electrical Equipment	0.2	0.9
Radio and Television Broadcasting and Wireless Communications Equipment	0.2	0.9
Pharmaceuticals and Medicines	0.2	0.9
Pumps and Compressors	0.2	0.8
All Other Chemical Products and Preparations	0.2	0.8

Source: Congressional Budget Office based on data from the Bureau of the Census.

Note: Numbers are free-alongside-ship values of total exports.

[a] Product categories correspond to five-digit codes of the North American Industrial Classification System.

U.S. Imports from China. As rapidly as the value of U.S. exports to China has grown, the value of imports from that country has risen even more quickly. From 1992 to 2002, imports increased from $27.4 billion to $133.5 billion, for an average annual rate of growth of 17.2 percent. The average annual rate from 2000 to 2002 was a slower 11.4 percent—still fast in comparison with imports from other major trading partners but probably slowed by the recession in the United States in 2001, which depressed demand.

With that rapid growth, China has moved from being the fifth largest supplier of U.S. imports in 1997 to the fourth largest in 2002 (*see Table 3*). As with exports, the growth's impact on output and employment in competing industries in the United States is more closely related to the absolute dollar value of the increase in imports than to the percentage growth in their value. Similarly, the benefit of import growth—lower prices for consumers and businesses that import intermediate goods for their production processes—is also more closely related to the absolute dollar value of increased imports. By that measure, China was the third most rapidly growing supplier of U.S. imports from 1992 through 2002 and the second from 1997 through 2002 (behind the European Union). So far in 2003, China's growth has caused it to surpass Mexico to become the United States' third largest source of imports.

Table 3. The Largest Suppliers of U.S. Imports

Country or Region	**U.S. Imports in 2002 in Billions of Dollars**	**U.S. Exports from January to July 2003 in Billions of Dollars**	**U.S. Imports in 2002 as a Percentage of Total Imports**
European Union	232.1	144.4	19.3
Canada	214.0	131.0	17.8
Mexico	136.1	79.7	11.3
China	**133.5**	**85.7**	**11.1**
Japan	124.6	70.1	10.4
South Korea	36.9	21.3	3.1
Taiwan	33.5	18.7	2.8
Malaysia	24.7	14.4	2.1
Brazil	16.7	10.8	1.4
Venezuela	15.8	9.4	1.3
Thailand	15.7	8.9	1.3
Singapore	15.1	9.2	1.3
Saudi Arabia	13.9	12.4	1.2
Israel	12.6	7.7	1.1
India	12.4	7.9	1.0
Memorandum:			
All Countries and Regions	1,202.4	741.2	100.0

Source: Congressional Budget Office based on data from the Bureau of the Census.
Note: Numbers are customs-insurance-freight values of general imports.

The largest categories (in terms of value) of U.S. imports from China are various kinds of electronic equipment (for example, computers and audio and video equipment), toys, footwear, and apparel (*see Table 4*).

Table 4. The Largest Categories of U.S. Imports to China in 2002

Product Category[a]	In Billions of Dollars	**As a Percentage of All U.S. Imports to China**
Computer Equipment	12.4	9.3
Dolls, Toys, and Games	11.1	8.3
Footwear	10.6	8.0
Audio and Video Equipment	9.3	6.9

Table 4. The Largest Categories of U.S. Imports to China in 2002—Continued

Product Category[a]	In Billions of Dollars	**As a Percentage of All U.S. Imports to China**
Semiconductors and Other Electronic Components	6.4	4.8
Household and Institutional Furniture	6.4	4.8
Other Manufactured Commodities	5.0	3.8
Women's and Girls' Apparel	4.8	3.6
Small Electrical Appliances	3.7	2.7
Lighting Fixtures	3.4	2.5
Other Leather Products	3.2	2.4
Other Plastics Products	2.8	2.1
Sporting and Athletic Goods	2.6	2.0
Radio and Television Broadcasting and Wireless Communications Equipment	2.3	1.7
Other Fabricated Metal Products	2.1	1.6
Telephone Apparatus	2.1	1.6
Commercial and Service-Industry Machinery	2.0	1.5
Other Apparel	1.7	1.3
Jewelry and Silverware	1.7	1.3
Apparel Accessories	1.7	1.3
Other General-Purpose Machinery	1.6	1.2
Men's and Boys' Apparel	1.5	1.2
Navigational, Measuring, Electromedical, and Control Instruments	1.5	1.1
Curtains and Linens	1.4	1.0
Pottery, Ceramics, and Plumbing Fixtures	1.2	0.9

Source: Congressional Budget Office based on data from the Bureau of the Census.

Note: Numbers are customs-insurance-freight values of general imports.

[a] Product categories correspond to five-digit codes of the North American Industrial Classification System.

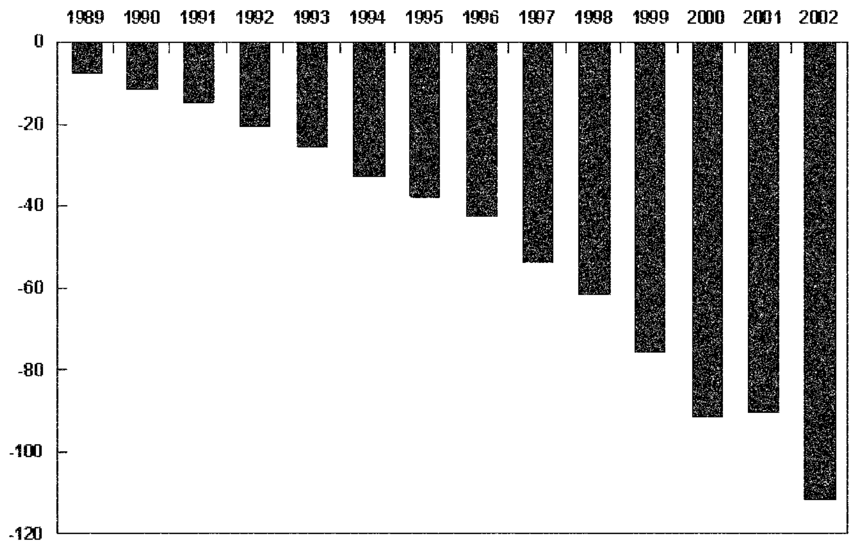
The United States' Trade Deficit with China. The United States' trade deficit with China increased from $19.9 billion in 1992 to $111.4 billion in 2002, growing at an average annual rate of 18.8 percent (*see Figure 8*). The average annual rate from 2000 to 2002 was a slower 10.4 percent, but it was still rapid in comparison with the growth rates of deficits with other major trading partners. That growth made the trade deficit with China in 2002 the largest of any of the United States' bilateral deficits (it was the second largest in 1997). So far in 2003, it remains the largest (*see Table 5*). In addition, the United States' deficit with China had the second largest dollar increase of any deficit with a U.S. trading partner from 1992 through

2002—although the increase was just barely smaller than the increase in the deficit with the European Union.

Figure 8.

The United States' Trade Balance with China, 1989 to 2002

(In billions of dollars)



Source: Congressional Budget Office based on data from the Bureau of the Census.

Note: The trade balance is calculated using free-alongside-ship values of total exports and customs-insurance-freight values of general imports.

Table 5. The Largest U.S. Trade Deficits

Country	**U.S. Trade Deficit in 2002 in Billions of Dollars**	**U.S. Trade Deficit from January to July 2003 in Billions of Dollars**	**U.S. Trade Deficit in 2002 as a Percentage of Total Trade Deficits**
China	**111.4**	**70.9**	**21.9**
European Union	88.4	57.2	17.4
Japan	73.2	39.9	14.4
Canada	53.2	33.1	10.4
Mexico	38.6	25.2	7.6
Taiwan	15.1	9.2	3.0
Malaysia	14.4	8.4	2.8
South Korea	14.3	7.4	2.8
Venezuela	11.4	8.1	2.2

Table 5. The Largest U.S. Trade Deficits—Continued

Country	U.S. Trade Deficit in 2002 in Billions of Dollars	U.S. Trade Deficit from January to July 2003 in Billions of Dollars	U.S. Trade Deficit in 2002 as a Percentage of Total Trade Deficits
Thailand	10.8	5.8	2.1
Saudi Arabia	9.1	9.8	1.8
India	8.4	5.2	1.6
Indonesia	7.8	4.5	1.5
Israel	5.6	3.7	1.1
Nigeria	5.2	5.7	1.0
Memorandum:			
All Countries	509.2	330.1	100.0

Source: Congressional Budget Office based on data from the Bureau of the Census.

Note: Numbers are based on free-alongside-ship values of total exports and customs-insurance-freight values of general imports.

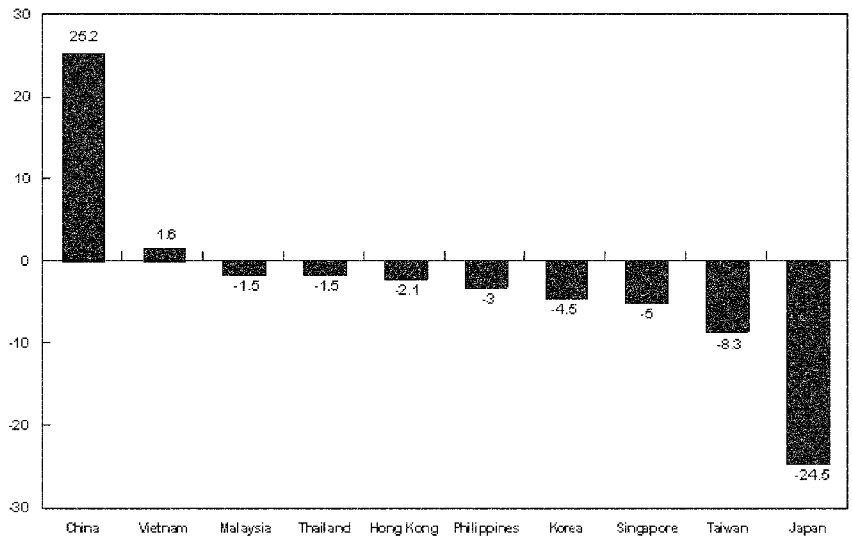
The United States' Multilateral Trade Balance

Individual bilateral trade balances, even the United States' growing deficit with China, generally are unimportant in and of themselves. At most, they have significance only as part of—and only to the extent that they affect—the United States' multilateral trade balance. Even though the deficit with China is larger than the deficit that the United States has with any other country, it accounts for only 21.9 percent of the nation's trade deficit with the world. Similarly, the increase in the trade deficit with China over the past 10 years represents only 22.7 percent of the increase in the United States' multilateral trade deficit; the corresponding number for the past five years is 19.6 percent (*see Figure 9*). The vast majority of U.S. trade and of the United States' trade deficit is with countries other than China.

Figure 9.

The United States' Trade Balances with China and the World, 1989 to 2002

(In billions of dollars)



Source: Congressional Budget Office based on data from the Bureau of the Census.

Note: Trade balances are calculated using free-alongside-ship values of total exports and customs-insurance-freight values of general imports.

Although many people focus exclusively on international conditions to explain the multilateral trade balance, in practice, some of its most important determinants have domestic origins. In particular, the difference between gross investment in the United States and gross domestic saving represents the nation's demand for capital inflows from the rest of the world. Those flows of resources into the U.S. economy provide funds to finance net imports and also influence the rate of exchange between the dollar and other currencies. Thus, changes in the bilateral terms between the United States and China that do not alter overall U.S. investment or saving decisions will not influence the multilateral balance.

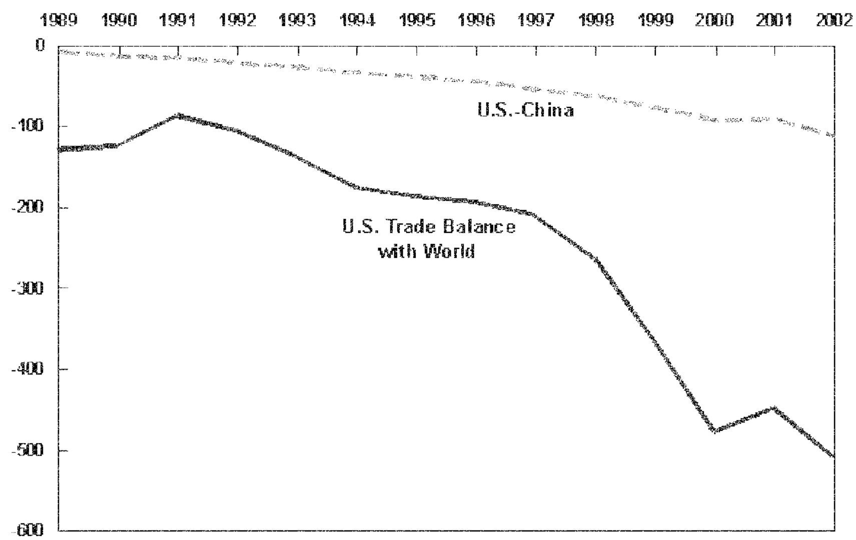
Saving and investment in the United States are determined by a complex mix of effects deriving from the business cycle, monetary policy, fiscal policy, the regulatory environment for business, the taxation of saving and investment, the desire to save for the future, and productivity growth. Although the Yuan's exchange rate against the dollar could, in principle, influence U.S. saving and investment to some extent, one would not expect the effects to be large. Rather, one would expect that much of any increase in U.S. imports from China resulting from a relatively low value of the Yuan would be offset by declines in U.S. imports from other countries—and indeed, that is what has happened.

Marcus Nolan, at the Institute for International Economics, estimated in the early to mid-1990s that 70 percent to 80 percent of increased U.S. imports from China displaced imports from other countries rather than U.S. production. CBO's more recent analysis indicates that the comparable figure for 1997 through 2002 was even higher. From 2000 through 2002, U.S. imports from China increased by $25.2 billion at the same time that imports from Japan fell by $24.5 billion and total imports from eight other Asian countries fell by $24.3 billion (*see Figure 10*).

Figure 10.

Change in U.S. Imports from China and Other Asian Trading Partners, 2000 to 2002

(In billions of dollars)



Source: Staff of the International Trade Commission in their analysis of September 24, 2003, for the Subcommittee on Trade of the House Committee on Ways and Means, updating an article by Michael Barry titled "Why Is the U.S. Trade Deficit with China So Big?" (*International Economic Review,* International Trade Commission, September/October 2001).

China has developed as a location of assembly, particularly for electronics and machinery; that is, it imports relatively high-value parts from other Asian countries and assembles them into finished goods for export. It also produces toys and apparel. Those unskilled labor-intensive tasks were carried out previously in other Asian (and a few non-Asian) countries but are now being performed in China because wages there are relatively low.

China's Exchange Rate Policy

China maintains a fixed value of 8.28 Yuan per dollar. By itself, such a nominal "peg" cannot affect the average real exchange rate (the exchange rate adjusted for any changes in prices in the respective trading countries) over the long term because the policy also causes offsetting effects on Chinese domestic prices. Through a policy known as sterilization, however, countries can, within limits, reduce the offsetting effects on prices and thereby influence the real exchange rate—and, consequently, trade flows. China has engaged in some sterilization, leading to the possibility of a lower real exchange rate for the Yuan. Because of the difficulty in determining the "correct," or market, value of any currency, considerable disagreement surrounds the question of how much (if at all) the Yuan may be undervalued. CBO found estimates by various analysts ranging from no undervaluation to as much as 40 percent, and considerable uncertainty is associated with each estimating approach.

The Peg Between the Yuan and the Dollar

China pegs the value of the Yuan to the dollar through the use of exchange controls in conjunction with its buying and selling of dollars for Yuan. If exporters' earnings and direct inflows of foreign investment result in more dollars than are needed to purchase imports, China requires that the dollars be turned in to the central bank in exchange for Yuan at the prescribed rate. The central bank then invests the dollars in various assets. At a later time, if a shortage of dollars develops, those assets (referred to as foreign exchange reserves) can be sold for dollars and the dollars provided to importers (or any others with a legally recognized need) in exchange for Yuan at the prescribed rate.

Over the past three years, that policy has caused China's central bank to purchase a large and rising number of dollars. The bank's reserves increased by $10.9 billion in 2000, $46.6 billion in 2001, $74.2 billion in 2002, and $103.7 billion in the four quarters ending with the second quarter of 2003. Roughly one-third of the reserves that were accumulated in 2001 and 2002 are invested in U.S. Treasury debt.

Effects on the Real Exchange Rate. Exports and imports are influenced by the real exchange rate. Thus, if a change in Chinese policy halved the value of the Yuan relative to the dollar but at the same time led to a doubling of domestic prices (in Yuan) in China, Chinese exports would continue to have the same dollar price and therefore would not change (all else being the same). The change in policy would have caused a change in the nominal exchange rate, but it would not have affected the real exchange rate.

By itself, China's policy of pegging the Yuan to the dollar would have no effect on the average real exchange rate over time. When the Chinese central bank uses Yuan to purchase excess dollars at the prescribed rate, it keeps the value of the Yuan from rising relative to the dollar. However, that policy also increases the supply of Yuan. If nothing is done to offset that increase, the growth in the money supply will ultimately result in higher domestic prices in China. The higher prices will then offset the effect that the decline in the value of the Yuan will have on the dollar prices of Chinese exports. Those prices will therefore remain unchanged—as will the ratio of the price in Yuan of Chinese imports to the price of Chinese domestic production. Hence, price-based incentives to purchase exports and imports will be unaffected.

If the central bank "sterilizes" its purchase of dollars by removing an offsetting quantity of Yuan from circulation, it can for a time avoid growth in the money supply and inflationary pressures and thus affect the real value of the Yuan relative to the dollar. However, the duration and effectiveness of sterilization are not unlimited, and consequently, neither is the ability to keep the real exchange rate from rising in the face of sustained purchases of foreign currency in exchange for domestic currency. China has in recent years engaged in some sterilization by, among other things, issuing central bank paper.[6] Nevertheless, its money supply has begun to grow more rapidly. M2, a broad measure of the money supply, grew by 12.3 percent in 2000, 15.0 percent in 2001, 19.4 percent in 2002, and 20.6 percent in the four quarters ending with the second quarter of 2003—a pace of money creation that is likely ultimately to put upward pressure on prices.

The Implications of China's Accumulation of Reserves. The substantial reserve accumulation associated with the pegging of the Yuan to the dollar has implications for both the United States and China. As noted earlier, a substantial fraction of China's reserves are invested in U.S. Treasury debt, raising the specter of a rise in U.S. Treasury yields and a fall in the dollar relative to other currencies should the Chinese sell a large sum of Treasury securities to buy assets denominated in other currencies. However, the combined holdings of China and Hong Kong represent only about 4 percent of outstanding U.S. Treasury securities.[7] Thus, any sale of dollar assets by China could spur a notable rise in U.S. interest rates only if that sale triggered a broader shift against dollar-denominated assets. A broad fall in the dollar relative to other currencies would help improve the U.S. trade balance, although at the expense of lower prices received for U.S. exports and higher prices paid for U.S. imports. China has strong reasons to avoid such a scenario: it would result in a capital loss on those assets for the Chinese as well as foreign exchange losses when they traded their dollars for other currencies.

Many economists note that the U.S. Treasury debt in which a substantial component of China's reserves is invested currently earns a very low rate of return and that those resources might be more productively invested in the Chinese economy. However, it is likely that not all of the investment inflows will be invested in China. To the extent that the reserves have resulted from inflows of funds speculating on

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[6] See the statement of John B. Taylor, Undersecretary of the Treasury for International Affairs, "China's Exchange Rate Regime and Its Effects on the U.S. Economy," before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Committee on Financial Services, October 1, 2003.

[7] China owned $102 billion, and Hong Kong $48 billion, in U.S. Treasury securities at the end of 2002. (Outstanding Treasury securities at the end of 2002 totaled $3.64 trillion.) China owns other dollar-denominated assets as well, but their inclusion is unlikely to change significantly the results of CBO's calculations. The effects on the yields of the types of securities involved would probably not be large if China were to sell them. The decline of the dollar relative to other countries' currencies would be increased somewhat as China exchanged the dollars for other currencies.

a revaluation of the Yuan, they will be needed when speculators undertake to reverse their positions.

Is the Yuan Undervalued?

The premise of the legislative proposals before the Congress, as reflected in their findings, is that the Yuan is substantially undervalued. That premise is by no means universally accepted, because determining the right value for any currency is difficult (at best).

China's large trade surplus with the United States is not a good indicator of proper or improper valuation of the Yuan because it leaves out not only trade with other countries but also trade in services and income on foreign investments. The current-account balance—a broad measure of the multilateral trade balance—includes trade in goods and services and income on foreign investments between China and all of its trading partners. A relatively substantial current-account balance combined with a capital-account surplus has led Morris Goldstein and Nicholas Lardy of the Institute for International Economics to calculate that the Yuan is undervalued by about 15 percent to 25 percent.[8]

In the end, the "correct" value for the Yuan is revealed by the markets when the currency is allowed to float—that is, to be bought and sold at market-determined prices with no government intervention. However, floating gives the "right" value only if the market works freely and without institutional distortions, such as controls on capital flows. As I will discuss later, some observers believe that if China both floated its currency and removed its capital controls, the Yuan would depreciate. (As recently as 1998, some other Asian countries that were forced to allow their currencies to float experienced depreciation.)[9]

Ernest Preeg of the Manufacturers Alliance and the Hudson Institute has performed a calculation that might approximate the exchange rate that would result from a float.[10] He looked at the large accumulation of dollars in Chinese reserves and determined how much higher the Yuan would have been if China had not accumulated those dollars. He concluded that the Yuan is undervalued by 40 percent. His calculation essentially ignores the role of the capital controls. It is hard to say whether, without those controls, Chinese citizens would hold more or fewer dollars than the Chinese government now holds, which is key to determining what the exchange rate would be. Furthermore, some observers have noted that one reason for the current upward pressure on the Yuan is that China is experiencing an inflow of funds by speculators hoping to gain from a revaluation that they consider likely in the near future. That inflow puts upward pressure on the currency that will cease once the Yuan is revalued or allowed to float and reaches its market equilibrium value.

Another approach is to look to history. Morgan Stanley's chief economist, Stephen Roach, notes that the trade-weighted average real value of the Yuan relative to other currencies is basically in line with the values it has had since 1998.[11] He concludes that the Yuan is not undervalued. Roach's analysis could also be taken a step farther: the Yuan is not currently out of line with the values it has had over the past 15 years (*see Figure 11*). (Note that a higher value of the index indicates a higher real value of the Yuan relative to other currencies.) However, it is not necessarily the case that a country's real exchange rate should remain constant over time. Under certain conditions, if a country experiences more-rapid productivity

[8] See the statement of Morris Goldstein, Institute for International Economics, "China's Exchange Rate Regime," before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Committee on Financial Services, October 1, 2003; Morris Goldstein and Nicholas Lardy, "Two-Stage Currency Reform for China," *Asian Wall Street Journal*, Op-Ed Section, September 12, 2003; and Morris Goldstein and Nicholas Lardy, "A Modest Proposal for China's Renminbi," *Financial Times*, Op-Ed Section, August 26, 2003.

[9] The Asian financial crisis of 1997 and 1998 saw the rapid devaluation of the currencies of Thailand, Malaysia, Indonesia, the Philippines, and South Korea when circumstances forced those nations to allow their currencies' value to float freely in the international currency markets. The differences between their circumstances then and China's now are significant. However, an important commonality is the relatively weak condition of those nations' internal capital markets and banking systems, particularly with regard to bad loans, and the current state of China's capital market and banking system. See International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues* (Washington, D.C.: International Monetary Fund, September 1998), Chapter 2.

[10] Ernest H. Preeg, "Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China," in C. Fred Bergstan and John Williamson, eds., *Dollar Overvaluation and the World Economy* (Washington, D.C.: Institute for International Economics, February 2003), pp. 273–274.

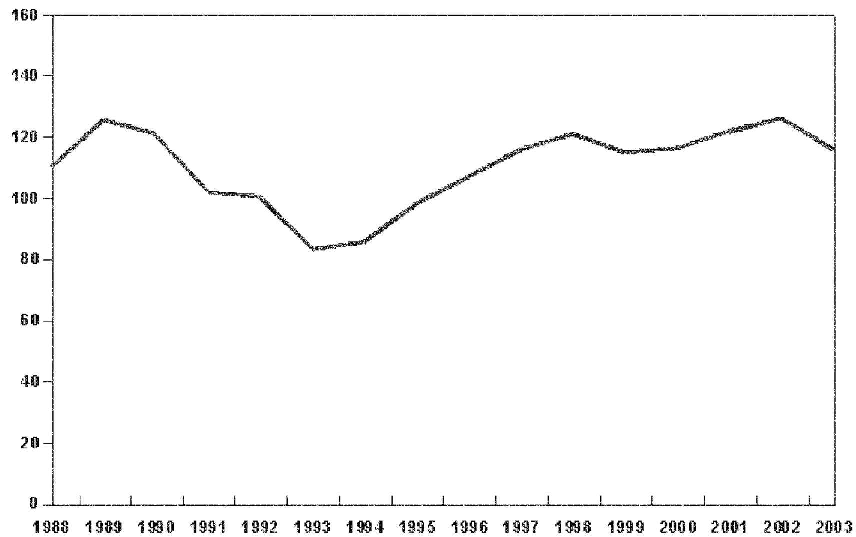
[11] Stephen S. Roach, *Getting China Right,* Special Economic Study (Washington, D.C.: Morgan Stanley, September 23, 2003), pp. 2–3.

growth relative to its trading partners in its tradable-goods sector than it does in its non-tradable-goods sector (which could well be the case with China), its real exchange rate could be expected to rise.[12]

Figure 11.

Real Effective Exchange Rate Index for the Chinese Yuan

(Index, 1995 = 100)



Source: Congressional Budget Office based on International Monetary Fund, International Financial Statistics (various years).

Note: The real effective exchange rate index is the ratio of an index of the Yuan's period-average exchange rate to a weighted geometric average of exchange rates for the currencies of selected countries and the euro area adjusted for movements in prices. Before 1994, China effectively had a dual exchange rate, with an official rate and a rate that prevailed in a swap market in which exporters, importers, and foreign-invested companies traded currencies. The index reflects a weighted average of the two exchange rates.

Likely Effects of the Bills Under Consideration

How the legislation now being considered might affect the U.S. economy would depend on the precise policy options chosen by the relevant parties. For the sake of illustration, I will discuss the effects of three prototypical choices: China allows the Yuan to float in foreign exchange markets and removes capital controls; China revalues the Yuan but thereafter continues to maintain a peg at the new, higher value; and the United States imposes a large tariff on imports from China. Although those policies do not constitute a comprehensive catalog of options consistent with the proposed legislation, their effects are representative of what one might anticipate.

Floating the Yuan

Broad consensus exists among analysts that over the long term, a movement toward a more flexible Yuan is desirable. Many observers caution, however, that immediately removing capital controls and floating the Yuan could be risky for China.[13] A large portion of the loans of Chinese banks are currently nonperforming

[12] See Maurice Obstfeld and Kenneth Rogoff, *Foundations of International Macroeconomics* (Cambridge, Mass.: MIT Press, 1996), pp. 210–216.

[13] The Yuan could be floated without liberalizing the capital controls, but the controls would significantly distort the resulting market exchange rate.

(that is, they are not being repaid or borrowers are behind on payments).[14] If China's restrictions on capital outflows were eliminated, Chinese citizens and businesses—partly out of a desire for diversification and partly because of bank-specific risk—would probably remove some of their funds from Chinese banks, leading to an outflow of funds to other countries. The outflow, if sufficiently severe, could cause financial stress or, in the extreme, precipitate the collapse of some banks. If the impact was large enough to induce contractionary pressures in the Chinese economy, that could, in turn, reduce the demand for U.S. exports.

In light of those risks, many observers argue that floating the Yuan and removing capital controls should be deferred until the Chinese banking system has been strengthened and the Chinese central bank is able manage inflationary and deflationary pressures. In short, day-to-day flexibility in the value of the Yuan should be accompanied by strengthening of China's domestic institutions and development of its capability to support such a "mature" foreign exchange policy.

Moreover, it is not clear that immediately floating the Yuan would even lead to an appreciation of the currency. The large outflow of funds occasioned by the liberalization of capital controls might actually cause the Yuan to depreciate. Also, as previously indicated, a portion of the buildup of reserves may reflect an inflow of funds by speculators in anticipation of gains from an expected revaluation. Speculators must convert their dollars to Yuan to achieve their aims, adding to the surplus of dollars that must be absorbed by the Chinese central bank in exchange for Yuan. Once the currency was allowed to float and it reached its market value, such speculative activity would cease, thereby ending that source of upward pressure on the Yuan.

The effects on U.S. manufacturing of floating the Yuan would depend on what happened to the value of the Yuan and to the Chinese economy. Predictions of exchange rate movements in floating markets are difficult and prone to error. The effects of exchange rate movements in either direction on U.S.-Chinese trade would have only a small effect on the U.S. multilateral trade balance and consequently on U.S. manufacturing employment. If the Yuan depreciated (as many economists think likely) and if financial problems in the banking sector led to reduced Chinese growth prospects, the U.S. bilateral trade deficit with China could increase. If the Yuan appreciated and major problems in the banking sector were avoided, the opposite could happen, but the ultimate positive effect on U.S. manufacturing employment would be small and mostly temporary.

Revaluation of the Yuan

Another possible policy would be a one-time revaluation of the Yuan to a higher value relative to the dollar and a subsequent peg of the Yuan to the dollar (or perhaps a peg to a basket of currencies, such as the dollar, the yen, and the euro) after the revaluation. (Some analysts have suggested as well that the Yuan be permitted to fluctuate in a modest band around the new value.)

Revaluing the Yuan would increase the U.S. price of imports from China. However, one would expect that the increases in prices paid by U.S. purchasers would be substantially less than the targeted percentage revaluation of the Yuan. One reason is that firms and their workers in China would be likely to absorb part of any increase. For most countries, revaluations of exchange rates are usually passed through to foreign-currency export prices only incompletely because exporters tend to reduce the home-currency prices of their products and narrow profit margins in response to such revaluations. To the extent that revaluation reduces foreign demand and the consequent reduced production yields lower average costs per unit produced, exporters can reduce their home-currency price and still maintain an adequate rate of profit. Moreover, even if average costs are unaffected, exporters (like any other business) are loath to easily give up hard-earned market share to currency fluctuations and will often accept some reduction in profit margins for as long as possible in an attempt to maintain that share.

A reason more specific to China is that its role as a location of final assembly means that only a comparatively small portion of the value of its exports derives from value added in China. The remainder represents the value of imported inputs that are assembled into finished exports. The final price of an export must cover the cost of the imported inputs plus the cost (in terms of wages, rent, and required return on capital) of the value added in China. However, only the value added in

[14] On September 22, 2003, the *Financial Times* reported: "Officially, the non-performing loans in the banking system account for just over 20 per cent of total loans. But independent observers, such as Standard and Poor's, the rating agency, put the figure at 45 per cent of GDP. By either measure, China has the weakest banking system of any large economy." See James Kynge, "Can China Keep its Economy on Track," *Financial Times,* October 22, 2003.

China would be made more expensive in dollar terms by an appreciation. The same appreciation that raised the dollar price of the export for a given Yuan price would also reduce the Yuan cost to China of the imported inputs. For that reason, the portion of the price of the finished exports accounted for by imported inputs would remain unchanged in dollar terms.

One group of analysts has estimated that only 20 percent to 30 percent of the value of Chinese exports represents value added in China.[15] If so, even with complete pass-through of the extra cost, a 20 percent appreciation of the Yuan would increase the final dollar price of the exports by only 4 percent to 6 percent (20 percent appreciation times 20 percent to 30 percent value added). Of course, some Chinese exports undoubtedly have less value than 20 percent added in China, and others may have considerably more than 30 percent added. Hence, the size of a revaluation's effect on price would vary with the good exported. Clearly, however, the effect for a large portion of Chinese exports would be substantially less than the percentage appreciation of the Yuan.

The ultimate impact of any resulting price increase on the volume of U.S. imports from China depends on how competitive China is compared with other countries. If the countries that previously assembled the products that China now assembles remain close competitors of China, then a price increase of plausible magnitude might be enough to induce a substantial shift in production from China back to those other countries. In effect, the process by which U.S. imports from China grew over time would to some extent be reversed. Imports from China would decline (or grow more slowly), but imports from the other countries would rise. The U.S. multilateral trade balance would increase only slightly, with just a small and temporary positive effect on U.S. manufacturing employment.

In practice, China appears to have a substantial competitive margin in many products, and the modest price increases that are likely if the Yuan is revalued would probably not be enough to shift the pattern of production and trade for those goods. Neither would they be enough, however, to induce U.S. consumers and businesses to reduce dramatically their demand for those products. Again, the U.S. multilateral trade balance would increase only slightly, with just a small and temporary positive effect on U.S. manufacturing employment.

A revaluation of the Yuan could also increase U.S. exports to China. However, because the value of those exports is only one-sixth that of U.S. imports from China, the dollar value of a revaluation's effect on exports would be smaller than that of the effect on imports. Also, as with imports, the revaluation would not be completely passed through to reductions of U.S. export prices denominated in Yuan. In contrast to China's exports, U.S. exports have a large percentage of domestic value added. Thus, there might be a larger price decline and U.S. exports to China would be likely to increase more than they would in the absence of the revaluation. However, any improvement in the U.S. multilateral trade balance would be modest and the impact on manufacturing employment slight and temporary.

Finally, independent of the extent to which any employment gains were to occur, a revaluation would hurt consumers and some trading sectors in the United States by reducing prices received for exports and increasing prices paid for imports.

Imposition of a Large Tariff on Imports from China

The effects on imports from China of imposing a large tariff would be greater than the effects of a corresponding revaluation of the Yuan because the tariff would effectively apply to the entire value of the imports—not just to the value added in China. The tariff would not, however, carry any corresponding incentive for U.S. exports to China. Viewed strictly from the perspective of the trade balance, the net effect of any large tariff would probably be to reduce the United States' bilateral trade deficit with China because the value of U.S. imports from China is six times as large as the value of U.S. exports to that country. Furthermore, as in the case of a revaluation, the decline in imports would be replaced mostly by increases in im-

[15] See the statement of Lawrence J. Lau, "Is China Playing by the Rules? Free Trade, Fair Trade, and WTO Compliance," at a hearing of the Congressional-Executive Commission on China, September 24, 2003; Xikang Chen, Leonard Cheng, K.C. Fung, and Lawrence J. Lau, "The Estimation of Domestic Value-Added and Employment Induced by Exports: An Application to Chinese Exports to the United States" (presentation to the Institute of Systems Science, Academy of Mathematics and Systems Science, Chinese Academyu of Sciences, Beijing, June 18, 2001); and Xikang Chen, Leonard Cheng, K.C. Fung, and Lawrence J. Lau, "The Estimation of Domestic Value-Added and Employment Induced by Exports: An Application to Chinese Exports to the United States," revised December 2001. The last of those sources was referenced by Stephen S. Roach in testimony before the Commission on U.S.-China Economic and Security Review on September 25, 2003, but CBO was unable to obtain the document for verification.

ports from other countries, so the effect on the U.S. multilateral trade balance would be small.

Moreover, a tariff raises the possibility of a corresponding Chinese policy against U.S. exports—especially if the U.S. tariff was ruled illegal by the World Trade Organization. As noted earlier, China was the sixth largest U.S. export market in 2002 and is currently the fifth largest; it has been the third most rapidly growing market over the past five years. When viewed in the larger context of trade retaliation, a tariff's net effect—positive or negative—on the multilateral trade balance is uncertain.

Mr. CRANE. Dr. Yager.

STATEMENT OF LOREN YAGER, PH.D., DIRECTOR, INTERNATIONAL AFFAIRS AND TRADE, U.S. GENERAL ACCOUNTING OFFICE

Dr. YAGER. Mr. Chairman and Members of the Committee, I am also pleased to be here today to discuss the challenges involved in ensuring that China honors its commitments to the WTO. This hearing takes place not only at a time of increasing trade between the United States and China, but also at a time of increasing concern about broader aspects of the U.S.-China relationship. Compliance with the WTO obligations is a central feature of China's economic relationship with the United States and other WTO Members; however, the mixed record of progress we have found in our analysis suggests that ensuring compliance will be difficult and will require sustained efforts from all the key players to be successful.

The main point of my testimony today is that Congress should expect significant progress from the Federal government in monitoring and enforcing China's implementation of its WTO commitments during this year; however, progress in these efforts may not necessarily translate into progress with regard to China's implementation.

First I will talk about three important factors that should bolster Congress's expectations, as well as key observations regarding China's implementation. My observations are based on a series of studies that we initiated at the request of this Committee and the Senate Committee on Finance. That work has included a comprehensive analysis of China's commitments, a survey of private sector representatives and an examination of first-year U.S. compliance efforts. I have also incorporated insights from GAO staff who have returned this week from travel and interviews with representatives of the private sector as well as U.S. agency officials in China.

The first factor that should bolster expectations is that Congress has provided increased resources for monitoring and enforcement of China's implementation. As a result, USTR and other key agencies have made significant increases in their staffing and have made organizational changes to enhance their ability to monitor and enforce China's implementation.

The second factor is that Administration officials assert that coordination of monitoring enforcement efforts both within the government and with the private sector are coming up to speed. Within the government, for example, USTR chairs the Subcommittee on China WTO compliance, which serves as one formal mechanism for interagency coordination. Additionally, agency staff have established a variety of mechanisms to work with the private sector which should enable them to take advantage of the collective understanding and experience with the commitments.

The third factor is that in the second year of China's WTO Membership, U.S. agency officials have more experience with China's compliance issues, both in terms of the scope of the problems as well as specific issues such as China's administration of its tariff rate quotas (TRQs). Further, the United States and other WTO Members can improve on the first year's disappointing experience of dealing with China multilaterally in the WTO. For example, the United States has more experience with the WTO's TRM for China, and USTR officials have noted their optimism about a more successful and effective second year review of China's implementation within the WTO.

Now, everything I have said up to this point refers to U.S. monitoring and enforcement efforts, but, of course, that is only half the equation. On the other side of the equation is China's willingness and capacity to comply with its commitments. Let me make a few observations now.

First, as we have mentioned in our reports, and as I mentioned in my written testimony, the enormous scope and complexity of the commitments make reform challenging. In addition, the general nature of some of the commitments makes it difficult to even determine if they have been fully implemented. In addition, Chinese implementation requires cooperation across the national, provincial and local levels in China as well as extensive coordination among various ministries and agencies. As many have observed, some of these key players may not believe it is in their interest to implement parts of the agreement, or, as we have also heard, some parts of the government may lack the technical capacity to implement the commitments.

Finally, during our recent work on the ground in China, some U.S. firms cited problems about China's uneven implementation of reforms across sectors as well as a more general concern of a lack of momentum within the Chinese government to implement some important commitments. For example, some representatives noted concerns about this lack of momentum hindering compliance with key commitments on trading rights and distribution. These are some of the key commitments for the years 2003 and 2004.

In closing, Mr. Chairman, a sustained approach from several key players, including the executive branch, the private sector, the WTO and the Congress, is essential to ensuring China's compliance this year. There are a number of positive factors that should bolster congressional expectations about improved compliance, but no one should underestimate the difficulty of ensuring that the commitments are effectively implemented this year.

Mr. Chairman, this concludes my testimony, and I would be happy to answer any questions.

[The prepared statement of Dr. Yager follows:]

Statement of Loren Yager, Ph.D., Director, International Affairs and Trade, U.S. General Accounting Office

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our observations on the challenges involved in ensuring that China honors its commitments to the World Trade Organization (WTO). This hearing takes place not only at a time of increasing trade between the United States and China, but also at a time of increasing concern about broader aspects of the U.S.-China relationship. Although China's implementation of its WTO commitments cannot fully eliminate those concerns, compliance with its WTO obligations is a central feature of China's economic relationship with the United States and other WTO members. However, as we have found in our analysis of the first year's efforts to monitor and enforce China's compliance with its WTO commitments, the scope and complexity of the agreement indicate that ensuring compliance will be difficult and will require sustained efforts from all the key players to be successful.

To provide you with an update on these issues, today I will discuss (1) the compliance challenges associated with the scope and complexity of China's WTO commitments and (2) the efforts to date of each of the key players involved in ensuring China's compliance with its WTO obligations: the executive branch, Congress, the private sector, and the WTO and its members. My observations are based on a series of studies that we initiated at the request of this Committee and of the Senate Committee on Finance. That work has included a comprehensive analysis of China's commitments,[1] our survey and interviews with the private sector representatives,[2] and our examination of first-year U.S. compliance efforts.[3] Before I turn to the specifics on these issues, let me provide a brief summary.

Summary

The comprehensive scope and complexity of China's WTO accession agreement present two main challenges for successfully monitoring and enforcing China's compliance with its obligations. First, the broad scope of the agreement, which covers numerous aspects of China's trade regime and market access commitments for goods and services, makes it difficult to determine if each commitment has been fully implemented. Similarly, the complexity of the agreement also presents challenges for assessing compliance. Specifically, some interrelated commitments are phased in at different times, and many commitments are so general in nature that it will be difficult to immediately assess compliance.

A sustained approach from several key players, including the executive branch, Congress, the private sector, and the WTO and its members, is essential to ensuring China's compliance. Since China's accession to the WTO, these actors have undertaken a range of efforts to ensure China's compliance: the executive branch has ramped up its resources for China monitoring and enforcement; Congress has enacted legislation focusing on China's adherence to its obligations; the private sector has continued to monitor China's progress and provide input on compliance priorities; and the WTO and its members have conducted an initial review of China's implementation. These compliance efforts encountered various challenges in the first year, thus demonstrating the need for a sustained approach to successfully ensure that China lives up to its WTO obligations.

Background

China became the 143rd member of the WTO on December 11, 2001, after almost 15 years of negotiations. These negotiations resulted in China's commitments to open and liberalize its economy and offer a more predictable environment for trade and foreign investment in accordance with WTO rules. The United States and other WTO members have stated that China's membership in the WTO provides increased opportunities for foreign companies seeking access to China's market. The United States is one of the largest sources of foreign investment in China, and total merchandise trade between China and the United States exceeded $145 billion in 2002, according to U.S. trade data. However, the United States still maintains a trade deficit with China: Imports from China totaled $124.8 billion, while exports totaled $20.6 billion in 2002. Through the first half of 2003, exports to and imports from China grew about 25 percent compared to the same period in the previous year.

The U.S. government's efforts to ensure China's compliance with its WTO commitments are part of an overall U.S. structure to monitor and enforce foreign governments' compliance with existing trade agreements.[4] At least 17 federal agencies,

[1] See U.S. General Accounting Office, World Trade Organization: Analysis of China's Commitments to Other Members, GAO–03–4 (Washington, D.C.: Oct. 3, 2002).

[2] See U.S. General Accounting Office, World Trade Organization: Selected U.S. Company Views About China's Membership, GAO–02–1056 (Washington, D.C.: Sept. 23, 2002).

[3] See U.S. General Accounting Office, World Trade Organization: First-Year U.S. Efforts to Monitor China's Compliance, GAO–03–461 (Washington, D.C.: Mar. 31, 2003).

[4] For more information on the overall roles and responsibilities of U.S. government agencies in monitoring and enforcing trade agreements, see U.S. General Accounting Office, International

Continued

led by the Office of the U.S. Trade Representative (USTR), are involved in these overall monitoring and enforcement activities. USTR and the departments of Agriculture (USDA), Commerce, and State have relatively broad roles and primary responsibilities with respect to trade agreement monitoring and enforcement. Other agencies, such as the departments of the Treasury and Labor, play more specialized roles. Federal monitoring and enforcement efforts are coordinated through an interagency mechanism comprising several management- and staff-level committees and subcommittees. The congressional structure for funding and overseeing federal monitoring and enforcement activities is similarly complex, because it involves multiple committees of jurisdiction. Congressional agencies, including GAO, and commissions also support Congress's oversight on China-WTO trade issues. In addition to the executive branch and congressional structures, multiple private sector advisory committees exist to provide federal agencies with policy and technical advice on trade matters, including trade agreement monitoring and enforcement.

Scope and Complexity of China's WTO Commitments Present Challenges for Ensuring Compliance

China's accession agreement is the most comprehensive of any WTO member's to date, and, as such, verifying China's WTO compliance is a challenging undertaking for two main reasons. The first reason is the scope of the agreement: The more than 800-page document spans eight broad areas and sets forth hundreds of individual commitments on how China's trade regime will adhere to the organization's agreements, principles, and rules and allow greater market access for foreign goods and services. The second reason is the complexity of the agreement: Interrelated parts of the agreement will be phased in at different times, and some commitments are so general in nature that it will not be immediately clear whether China has fully complied with its obligations in some cases.

Scope of Commitments Poses Inherent Compliance Issues

The comprehensive scope of China's WTO accession agreement represents a challenge for the U.S. government's compliance efforts. The commitments cover eight broad areas of China's trade regime, including import regulations, agriculture, services, and intellectual property rights. Within these eight broad areas, we identified nearly 700 individual commitments that China must implement to comply with its WTO obligations. China has also committed to lower a variety of market access barriers to foreign goods. These obligations include commitments to reduce or eliminate tariffs on more than 7,000 products and eliminate nontariff barriers on about 600 of these products. Additionally, China made commitments to allow greater market access in 9 of 12 general services sectors, including banking, insurance, and telecommunications.

The scope of compliance problems raised in the first year of China's membership reflects the scope of the agreement itself. Although the executive branch's first-year assessment of China's implementation of its WTO commitments acknowledged China's effort and progress in some areas, the assessment also noted compliance problems in all eight broad areas of China's trade regime.[5] In particular, the executive branch emphasized problems in agriculture, services, and intellectual property rights, as well as a crosscutting concern about transparency. Some preliminary assessments of China's second-year implementation from the private sector suggest that many of those problems persist and that concern about the number and scope of compliance issues continues to increase.

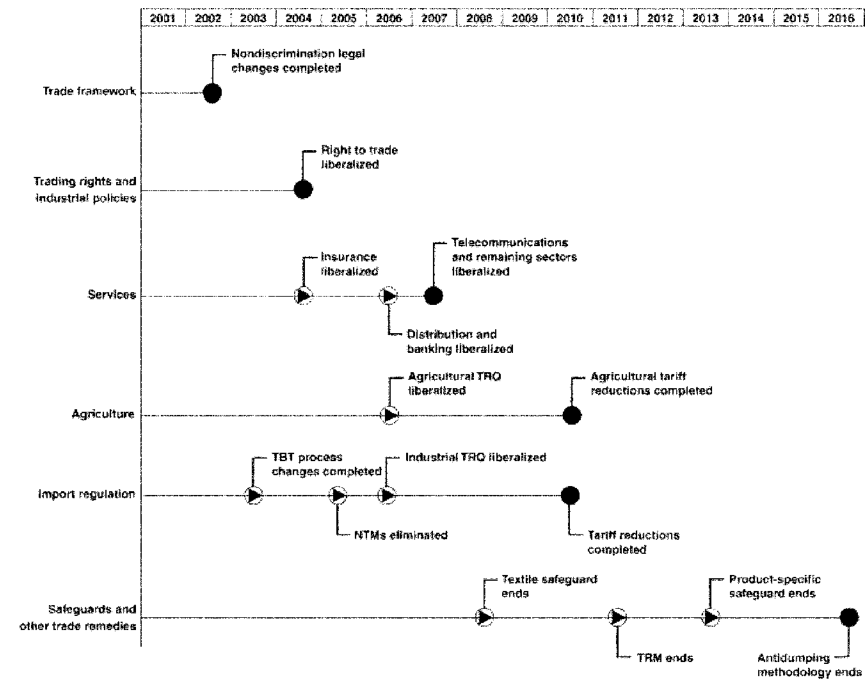
Complexity of Agreement Presents Additional Challenges for Assessing Compliance

While many of China's commitments were due to be phased in upon China's accession to the WTO in 2001, a number of interrelated commitments are scheduled to be implemented over extended time frames. For example, commitments on trading rights and distribution are not scheduled to be fully phased in until the end of 2004 and 2006, respectively. As a result, foreign businesses will be unable to fully integrate import, export, and distribution systems until that time. Additionally, although market access for most goods and services will be phased in by 2007, some tariffs will not be fully liberalized until 2010. (See fig. 1.)

Trade: Strategy Needed to Better Monitor and Enforce Trade Agreements, GAO/NSIAD–00–76 (Washington, D.C.: Mar. 14, 2000).

[5] See U.S. Trade Representative, 2002 Report to Congress on China's WTO Compliance (Washington, D.C.: Office of the U.S. Trade Representative, Dec. 11, 2002).

Figure 1: Summary of Key Phase-in Dates for China's WTO Commitments, 2001–2016



Source: GAO.

Legend
NTM: nontariff measure
TBT: technical barriers to trade
TRQ: tariff-rate quota
TRM: transitional review mechanism

The varying nature of China's commitments also complicates U.S. government compliance efforts. On the one hand, some of China's WTO obligations require specific actions from China, such as reporting particular information to the WTO, or lowering a tariff on a product. Assessing compliance with these specific types of commitments is relatively easy. On the other hand, a significant number of commitments are more general in nature and relate to systemic changes in China's trade regime. For example, some commitments of this type require China to adhere to general WTO principles of nondiscrimination and transparency. Determining compliance with these more general types of commitments is more difficult and can complicate the dialogueue over achieving compliance.

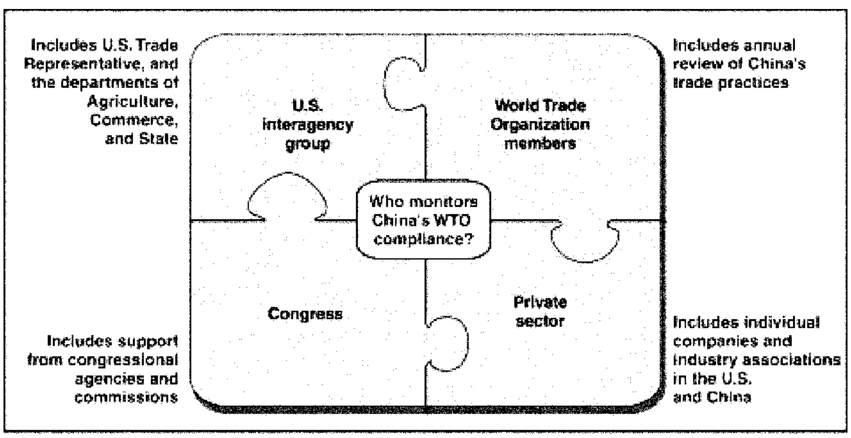
It is useful to note that many private sector representatives told us that implementing these general types of commitments, such as those that relate to the rule of law, was relatively more important than carrying out specific commitments to increase market access and liberalize foreign investment in China. Specifically, China's commitments in the areas of transparency of laws, regulations, and practices; intellectual property rights; and consistent application of laws, regulations, and practices emerged as the most important areas of China's accession agreement in our September 2002 survey of and interviews with U.S. companies operating in China.[6] However, private sector representatives also indicated that they thought these rule-of-law-related commitments would be the most difficult for China to implement.

[6] For a further description of our results, see GAO–02–1056.

Sustained Effort from Key Players Required to Ensure China's Compliance, but First-year Experience Demonstrates Challenges

Because China is such an important trading partner, ensuring China's compliance with its commitments is essential and requires a sustained effort on the part of the executive branch, Congress, the private sector, and the WTO and its other members. (See fig. 2.) For example, the executive branch has extensive involvement in monitoring and enforcing China's commitments, and additional resources and new structures have been applied to these tasks. However, the U.S.'s first-year experience showed that it takes time to organize these structures to effectively carry out their functions and that progress on the issues can be slow. In addition to the executive branch's efforts, Congress has enacted legislation, provided resources, and established new entities to increase oversight of China's compliance. The private sector also has undertaken a wide range of efforts that provide on-the-ground information on the status of China's compliance efforts and input to the executive branch and to Congress on priorities for compliance efforts. Finally, the WTO has existing mechanisms as well as a new, China-specific mechanism created as a means for WTO members to annually review China's implementation of its commitments. Nonetheless, despite the involvement of all of these players in the first year, the United States will need a sustained—and cohesive—approach to successfully carry out this endeavor.

Figure 2: Multifaceted Approach Essential to Ensuring China's WTO Compliance



Source: GAO.

Key Executive Branch Agencies Have Increased Focus on China's Compliance, but First-Year Efforts Demonstrate Challenges

China's accession to the WTO has led to increased monitoring and enforcement responsibilities and challenges for the U.S. government. In response to these increased responsibilities, USTR and the departments of Commerce, Agriculture, and State have undertaken various efforts to enhance their ability to monitor China's compliance with its WTO commitments. Agencies have reorganized or established intra-agency teams to improve coordination of their monitoring and enforcement efforts. Additionally, the agencies have added staff in Washington, D.C., and overseas in China to carry out these efforts. For example, estimated full-time equivalent staff in key units that are involved in China monitoring and enforcement activities across the four agencies increased from about 28 to 53 from fiscal years 2000 to 2002, with the largest increases at the Department of Commerce. On a broader level, USTR has established an interagency group to coordinate U.S. government compliance activities. The interagency group, which utilizes the private sector to support its efforts, was very active in monitoring and responding to issues during the first year of China's membership. Nevertheless, it took some time for agencies to work out their respective roles and responsibilities in the interagency group.

Monitoring and enforcing compliance with WTO requirements is a complex and challenging task, as shown by our 2002 assessment of the U.S. government's efforts to ensure China's compliance with commitments regarding administration of tariff-rate quotas (TRQ)[7] for certain bulk agricultural commodities.[8] TRQ implementation problems in 2002 included concerns about Chinese authorities missing deadlines for issuing TRQs on certain bulk agricultural commodities; disagreement over whether China's interpretation of its commitments met WTO requirements; and questions about whether China's administrative practices were in keeping with its obligations. The United States has undertaken both bilateral and multilateral efforts to settle these complex issues. The large number of U.S. government activities on these issues alone, which still are not fully resolved, included at least monthly engagements with China and illustrates the extensive effort agencies must undertake to identify problems, gather and analyze information, and respond to some issues.

Congressional Focus on China Compliance Issues Has Increased Substantially

Congress has had an active role in overseeing trade relations between the United States and China and in setting expectations for vigilant monitoring and enforcement of China's WTO commitments. In the U.S.-China Relations Act of 2000,[9] Congress found that for the trade benefits with China to be fully realized, the U.S. government must effectively monitor and enforce its rights under China's WTO agreements. To accomplish this, Congress

- authorized additional resources at USTR and the departments of Commerce and Agriculture;
- called for an annual review of China's compliance in the WTO;
- established the Congressional-Executive Commission on the People's Republic of China to monitor China's compliance with human rights and the development of the rule of law in China;
- established a Task Force on the Prohibition of Importation of Products of Forced Prison Labor from China;
- authorized a program to conduct rule of law training and technical assistance in China; and
- enacted legislation implementing China's WTO commitment allowing WTO members to apply a product-specific safeguard when increases in Chinese imports threaten or cause injury to domestic industry.

Congress also required that the executive branch issue several China trade-related reports to assist its continuing oversight. These requirements included USTR's annual report on China's compliance, which is based in part on input from the general public. In addition, this Committee, together with the Senate Finance Committee (on a bipartisan basis), requested that we continue our work on China-WTO issues and report on China's compliance, executive branch efforts, and U.S. business views over 4 years. Finally, congressional committees and commissions have held at least 35 China-focused hearings since 2001—a further indication of congressional involvement in U.S.-China issues.

Private Sector Plays Key Role in Monitoring China's Compliance

U.S. businesses operating in China provide valuable assistance in monitoring the status of China's implementation of its WTO commitments, and, as such, effective coordination between the U.S. government and the private sector is essential. For example, industry-specific expertise and input from within the private sector are indispensable components for determining whether the scores of highly technical laws and regulations that the Chinese government issues are WTO compliant and being implemented. Further, private sector industry and business associations are active in conducting their own analyses and issuing reports on China's WTO compliance, providing input to congressional committees and commissions, engaging the Chinese on specific WTO issues, and representing their members' interests to the U.S. government in order to inform the U.S.'s compliance priorities.

WTO Has General and China-specific Mechanisms to Ensure Compliance

The WTO's framework of more than 20 multilateral agreements covers various aspects of international trade and sets forth the rules by which China and other members must abide. Notably, the WTO's dispute settlement mechanism is intended to give all WTO members access to a formal mechanism for pursuing and resolving WTO-related compliance issues with other members, including China. Thus far, no WTO member has initiated a dispute settlement case against China, although some

[7] Under China's TRQ commitments, a specific quantity of certain agricultural bulk commodities is to be allowed in at a low duty, while imports above that quota face higher tariffs.

[8] See GAO–03–461.

[9] This constituted a major part of the legislation that led to China's receiving permanent normal trade relations status. See Pub. L. No. 106–286, 114 Stat. 880.

Members of Congress and private sector groups have urged the U.S. government to initiate a case related to China's administration of TRQs.

Another WTO mechanism relates specifically to China. China's accession commitments created a Transitional Review Mechanism (TRM), as a means for WTO members to annually review China's implementation of its commitments for 8 years, with a final review in the 10th year following China's accession.[10] Just as establishing the TRM was one of the more challenging issues to negotiate with China, implementing the TRM process during the first year (2002) also proved challenging. Disagreement among WTO members, including China, over the form, timing, and thoroughness of the TRM led to a limited initial review of China's trade practices. The review did not meet U.S. expectations and illustrated the challenges of gaining consensus with China and other members within this multilateral forum over implementation issues. Although U.S. officials cited benefits from participating in the initial review, they expressed disappointment over the first-year results. U.S. officials are hopeful that future reviews will be more comprehensive. The second-year TRM is under way, but it is still too early to determine if the current review will meet U.S. and other WTO members' expectations.

Concluding Observations

In assessing China's first-year implementation efforts, the executive branch, other WTO member government officials, and many private sector representatives observed that, despite several first-year compliance problems, China had demonstrated a willingness to implement its WTO commitments. For example, the executive branch noted China's progress in revising the framework of laws and regulations governing various aspects of China's trade regime. In the second year of China's membership, however, concerns about the number of compliance problems have grown, as well as the number of events that have potentially interfered with China's implementation of its commitments. Specifically, some observers have noted events such as changes in China's central government leadership, reconfigurations of key ministries, a growing concern about unemployment and labor unrest, and the SARS outbreak as possibly temporarily interrupting progress on implementation.

In closing, Mr. Chairman, the theme of my testimony is that a cohesive and sustained approach is necessary to monitor and enforce China's commitments to the WTO. I believe that this hearing that focuses on the key elements of the U.S.-China economic relationship and brings together three of the key players is exactly the kind of oversight that is necessary to ensure that a cohesive and sustained approach is actually carried out.

Mr. Chairman and Members of the Committee, this concludes my prepared statement. I would be happy to answer any questions on my testimony that you may have.

Mr. CRANE. Thank you. Dr. Rogowsky.

STATEMENT OF ROBERT A. ROGOWSKY, PH.D., DIRECTOR OF OPERATIONS, UNITED STATES INTERNATIONAL TRADE COMMISSION

Dr. ROGOWSKY. Thank you very much, Mr. Chairman. I want to thank you and the Committee for the opportunity to share some of the knowledge and data the staff at the USITC is developing on China. I have provided written testimony for the record. I should note to start that the testimony provided is not an official commissioned document, and so it does not necessarily reflect the views of the Commission as a whole or any individual Commissioner.

In my few moments, I want to highlight several facts that are relevant to the issue of America's trade deficit with China. The relationship with China is if nothing dynamic. The bilateral trade deficit has grown over 900 percent since 1990 and nearly 24 per-

[10] The TRM is additional to WTO's trade policy review mechanism, which provides for a broad review of the trade regimes of all WTO members on a scheduled basis. However, WTO members viewed the trade policy review mechanism as insufficient to oversee China's implementation of its commitments and pursued the TRM.

cent in 2002 alone. From 1996 to 2002, U.S. exports to China increased 74 percent, and U.S. imports from China increased 144 percent. In 2002, China's first full year as a Member of the WTO, U.S. exports to China increased 14 percent, while U.S. imports increased 22 percent.

China's imports are moving up the sophistication ladder. In 1990, only 3 percent of China's exports to the United States were non-electrical machinery. Now they are 16 percent. Similarly, electrical machinery grew from 12 percent to 20 percent. United States imports of computers, peripherals and parts from China rose 42 percent in 2002, and U.S. imports of consumer electronics except televisions increased by 31 percent in 2002. This increased competitiveness can be attributed in large part to consumer electronic companies based in other Asian countries shifting manufacturing to China. It is reported that as much as 20 percent of Japan's consumer electronics capacity has moved to China. United States imports of telephone apparatus expanded 45 percent in 2002 mostly because U.S. and European producers have established production facilities in China. Also, U.S. imports of games, mostly video games in China, nearly doubled in 2002, and that is because a major producer moved from Japan to China.

The U.S. trade data from 2002 showed that imports to China are increasing, while imports into the United States from almost every other Asian economy have decreased. United States imports from China increased $25 billion over the past 2 years. Imports from Japan decreased $24 billion. All this was predicted in the USITC's 1999 study of China's WTO accession. This trend is especially notable for more advanced products. In 1990, China supplied less than 1 percent of U.S. imports of non-electrical machinery and about 3 percent of electrical machinery. By 2002, these shares had increased to 13 percent and 16 percent respectively. Virtually all this increase came at the expense of Japan, whose share of U.S. imports fell to less than half of its original level in each sector.

In contrast to a downward trend for U.S. exports worldwide, U.S. exports to China increased to 14 percent in 2002. United States imports of semiconductors and integrated circuits to China rose 31 percent in 2002. This increase is attributed to China's rapidly growing demand for these products in the manufacture of telecommunications equipment, computer hardware and consumer electronics. According to industry observers, about 95 percent of China's semiconductor demand is currently met by imports because of difficulties related to protecting IPRs and creating wholly owned foreign ventures. However, even as their own production of semiconductors grows in China, largely fueled by Taiwanese investments, exports of U.S. semiconductor manufacturing equipment has followed, growing 63 percent.

China, as Napoleon predicted, now awakened, is shaking the world. Asia in particular is undergoing dynamic shifts in trade flows, investment surges and production patterns. It is not surprising. The various perceived problems are structural, or, more precisely, they arise from the shifts from one structural equilibrium to another. The new equilibrium as yet has not been determined. It is this disequilibrium that creates the tension. Again, it is not terribly surprising.

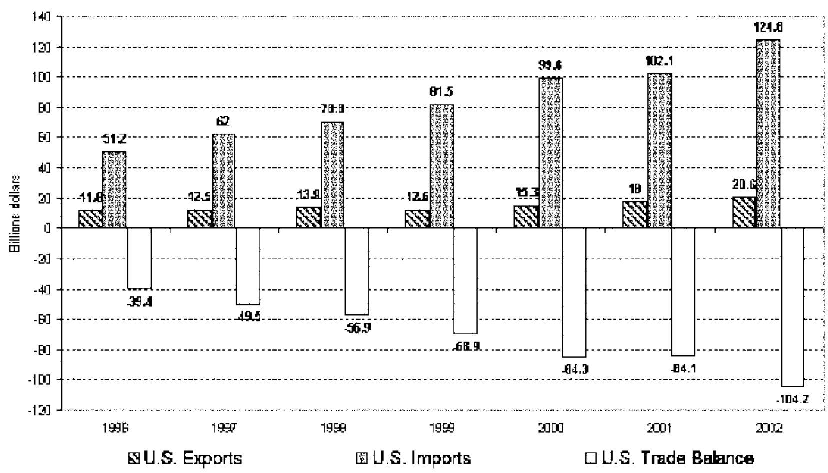
Thank you for this opportunity, and I would be happy to answer any questions.

[The prepared statement of Dr. Rogowsky follows:]

Statement of Robert A. Rogowsky, Ph.D., Director of Operations, United States International Trade Commission

The U.S. deficit in merchandise trade with China reached $104.2 billion in 2002, with U.S. exports totaling $20.6 billion and U.S. imports totaling $124.8 billion (figure 1).[1] The bilateral trade deficit has grown 907.7 percent since 1990, and 23.9 percent in 2002 alone. In terms of total trade, in 2002, China is the United States' 4th largest trading partner. It recently passed Japan as the United States' third largest importer. But as a share of the total U.S. trade deficit, the trade deficit with China is larger (20 percent) than the shares of the top three trading partners, Canada (13 percent), Mexico (9 percent), and Japan (14 percent).

Figure 1
U.S. trade with China: U.S. exports, U.S. imports, and U.S. trade balance, 1996-2002



Source: Official statistics of the U.S. Department of Commerce.

From 1996 to 2002, U.S. exports to China increased 74.2 percent ($8.8 billion), while U.S. imports from China increased 143.7 percent ($73.6 billion). In 2002, China's first full year as a member of the World Trade Organization, U.S. exports to China increased 14.4 percent ($2.6 billion), while U.S. imports increased 22.3 percent ($22.7 billion). U.S. imports from China have increased in all major categories. The largest increases in broad (2-digit HTS) categories of imports from China from 2000 to 2002 included electrical machinery (25.3 percent), non-electrical machinery (51 percent), toys and games (16.6 percent), footwear (11.3 percent), furniture and bedding (37.8 percent), leather products (15.5 percent), plastic products (29.4), precision instruments (22 percent), and other apparel (45 percent) (table 1).

[1] The reported trade data reflect total imports for consumption and domestic exports, the definitions used by the U.S. Department of Commerce in measuring the trade balance.

Table 1. U.S. imports from China, classified by 2-digit HTS chapter, 2000–2003
Ranked by 2002 import level (*Billions of dollars*)

HTS	Description	2000	2001	2002	2002 YTD	2003 YTD	Change 2000–2001	Change 2001–2002	Change 2000–2002	Change 2002 YTD–2003 YTD
							-------Percent-------			
85	Electrical machinery	19.4	19.6	24.3	9.7	11.1	1.3	23.7	25.3	14.6
84	Non-electrical machinery	13.4	13.7	20.2	9.2	13.3	2.6	47.3	51.0	45.6
95	Toys, games, sports equipment	12.4	12.2	14.4	4.8	5.6	-1.4	18.2	16.6	16.8
64	Footwear	9.2	9.8	10.2	4.9	5.4	6.1	4.9	11.3	9.3
94	Furniture and bedding	7.2	7.5	9.9	4.6	5.7	4.0	32.4	37.8	24.9
62	Woven apparel	4.2	4.1	4.5	2.0	2.7	-0.4	7.7	7.2	35.7
42	Leather products	3.8	4.0	4.4	1.7	2.0	2.8	12.3	15.5	19.5
39	Plastic products	2.9	3.2	3.8	1.8	2.1	11.0	16.6	29.4	16.1
90	Precision instruments	2.7	2.7	2.8	1.2	1.4	-0.4	0.8	0.4	22.3
61	Knit apparel	2.0	2.3	2.6	0.9	1.1	11.9	14.8	28.5	30.0
73	Iron or steel products	1.9	2.1	2.5	1.2	1.6	12.3	19.9	34.6	34.4
87	Motor vehicles	1.9	1.5	1.9	1.0	1.2	-20.9	25.3	-0.8	20.2
63	Other apparel	1.1	1.2	1.6	0.7	1.1	9.5	37.1	50.2	45.8
83	Miscellaneous metal products	0.9	1.0	1.3	0.6	0.7	15.3	29.6	49.5	15.5
82	Metal tools	0.9	1.0	1.2	0.5	0.6	8.9	22.0	32.8	22.2
	Other	15.7	16.1	19.1	8.4	10.5	2.8	18.7	21.9	23.8

Source: Official statistics of the U.S. Department of Commerce.

Some specific product categories have shown remarkable growth from 2000 to 2002. Of the leading 25 import categories (8 digit HTS), ranked by largest dollar increase during 2000–2002, 12 showed growth of more than 150 percent. All but 5 grew by more than 50 percent, and several grew several hundred fold. Sixteen items were electrical or non-electrical machinery (table 2).

Rapid U.S. import growth has continued into 2003. U.S. imports during the first 6 months of 2003 are 24.5 percent greater than during the first 6 months of 2002. As a new member of the WTO, China became eligible for the phase-out of textile quotas imposed by the Multi-fiber Agreement and currently undergoing elimination under the Agreement on Textiles and Clothing (ATC). Imports of several apparel items showed significant increases during 2000–2002, due to the phase out of certain quotas.[2] As quotas end January 2005, many expect this growth to increase substantially.

Even as items such as textiles have grown rapidly, the trends show a qualitative change in China's exports and its domestic economy. China has traditionally exported labor-intensive, simple manufacture products. Since 1990, however, China has increasingly focused its exports to the United States on higher value added products. Non-knit apparel, 13.8 percent of China's exports to the United States in 1990, declined to just 3.6 percent in 2002 (table 3). The relative shares of other products have similarly dropped, including those for knit apparel; mineral fuels; toys, games, and sports equipment; leather products; fish; and footwear. While only 3.1 percent of China's exports to the United States in 1990 were non-electrical machinery, this share had increased to 16.2 percent of China's exports by 2002. Similarly, the share of electrical machinery in China's exports to the United States increased from 12.6 percent in 1990 to 19.4 percent (table 2). Reflecting China's en-

[2] The American Textile Manufacturers Institute estimates that imports from China of garments released from quota restrictions on January 1, 2001 more than doubled in the following 12 months. Reported in EIU Veiwswire, September 15, 2003, p. 1.

hanced production capacity, U.S. imports of computer, peripherals, and parts from China rose sharply, advancing by $4.4 billion (42 percent) to $14.9 billion in 2002.

Table 2. U.S. imports from China, classified by 8-digit HTS, ranked by absolute change during 2000–2002

HTS No.	Description	2000	2001	2002	2002 Jan.–June	2003 Jan.–June	Change 2000–2002	Percent Change 2000–2002
		----------*Million dollars*----------						*Percent*
8521.90.00	Video recording or reproducing apparatus, other than magnetic tape-type.	609.9	1,262.1	2,171.8	758.3	781.3	1,562.0	256.1
8525.20.90	Transmission apparatus incorporating reception apparatus (other than transceivers) for radiotelephony, radiotelegraphy, radiobroadcasting or television.	300.2	653.0	1,559.7	454.8	776.1	1,259.5	419.6
9504.10.00	Video games of a kind used with a television receiver and parts and accessories thereof.	336.0	398.3	1,571.4	347.0	674.1	1,235.3	367.6
8471.60.45	Display units for ADP machines, with a non-color cathode-ray tube or non-CRT display type n.e.s.o.i.,[1] not entered with the rest of a system.	99.7	225.2	1,322.9	530.3	1,142.8	1,223.2	1226.4
8473.30.10	Printed circuit assemblies for ADP machines.	1,729.6	1,775.5	2,418.9	1,155.3	1,282.4	689.3	39.9
8471.30.00	Portable digital automatic data processing machines, not over 10 kg, consisting of at least a central processing unit, keyboard and display.	11.1	22.5	632.2	50.7	1,468.9	621.1	5614.5
9403.60.80	Furniture (other than seats & other than of 9402) of wooden (other than bentwood) nesoi.	979.8	1,072.6	1,570.1	686.5	882.7	590.3	60.2

Table 2. U.S. imports from China, classified by 8-digit HTS, ranked by absolute change during 2000–2002—Continued

HTS No.	Description	2000	2001	2002	2002 Jan.–June	2003 Jan.–June	Change 2000–2002	Percent Change 2000–2002
8473.30.50	Parts and accessories of the ADP machines of heading 8471, not incorporating a CRT, n.e.s.o.i.[1].	1,605.0	1,711.7	2,175.2	947.4	1,115.3	570.3	35.5
6403.99.90	Footwear, outer soles of rubber/plastics/leather & uppers of leather, not covering ankle, for women/child/infants, n.e.s.o.i.[1] over $2.50/pair.	1,821.6	2,156.3	2,391.6	1,177.2	1,423.9	570.0	31.3
8525.40.40	Digital still image video cameras	173.8	176.3	637.2	162.7	416.5	463.3	266.6
9403.50.90	Furniture (other than seats) of wood (other than bentwood), of a kind used in the bedroom & not designed for motor vehicle use.	358.8	477.4	817.3	347.4	525.5	458.6	127.8
8528.12.32	Non-high definition color television reception apparatus, nonprojection, w/CRT, video display diag. ov 35.56 cm, not incorp. a VCR or player.	12.0	18.6	467.3	157.8	159.2	455.4	3806.8
8471.70.60	ADP storage units other than magnetic disk, not in cabinets for placing on a table, etc., not entered with the rest of a system.	768.4	837.6	1,156.3	627.5	503.6	387.9	50.5
9403.20.00	Furniture (other than seats) of metal nesoi, other than of a kind used in offices.	671.4	770.1	1,016.7	537.2	715.7	345.2	51.4
8527.31.60	Radio broadcast receivers combined with sound recording or reproducing apparatus, n.e.s.o.i.[1].	140.1	216.1	462.5	157.2	143.4	322.4	230.1

6403.99.60	Footwear, outer soles of rubber/plastics/leather & uppers of leather, not covering ankle, not welt, for men, youths and boys, n.e.s.o.i.[1].	1,561.8	1,620.5	1,865.1	899.2	1,057.7	303.3	19.4
8471.60.62	Other ADP laser printer units not capable of more than 20 pages per minute, not entered with the rest of a system, n.e.s.o.i.[1].	165.1	368.8	466.8	172.7	372.1	301.7	182.7
8471.60.51	Assembled ADP laser printers incorporating at least media transport, control and print mechanisms, capable of more than 20 pages/per minute.	152.5	353.8	436.8	223.3	64.1	284.2	186.4
4202.92.30	Travel, sports and similar bags with outer surface of textile materials other than of vegetable fibers.	159.7	154.7	429.9	198.1	342.7	270.2	169.2
8509.10.00	Electromechanical vacuum cleaners, with self-contained electric motor, for domestic uses.	179.2	337.0	436.4	181.7	228.1	257.2	143.5
8471.60.64	Other ADP ink jet printer units not entered with the rest of a system, n.e.s.o.i.[1].	338.9	401.0	595.8	184.4	187.5	256.9	75.8
9505.10.25	Articles for Christmas festivities, ornaments, not of glass or wood.	759.9	893.1	1,007.3	152.3	154.4	247.4	32.6
9503.70.00	Toys n.e.s.o.i.,[1] put up in sets or outfits and parts and accessories thereof.	744.1	779.2	960.7	276.9	273.8	216.6	29.1
8471.60.61	Other ADP laser printer units capable of more than 20 pages per minute, not entered with the rest of a system, n.e.s.o.i.[1].	95.8	199.8	305.4	173.1	126.7	209.6	218.8

Table 2. U.S. imports from China, classified by 8-digit HTS, ranked by absolute change during 2000–2002—Continued

HTS No.	Description	2000	2001	2002	2002 Jan.–June	2003 Jan.–June	Change 2000–2002	Percent Change 2000–2002
8519.99.00	Sound reproducing apparatus n.e.s.o.i.,[1] not incorporating a sound recording device.	712.4	754.9	920.6	369.7	299.9	208.2	29.2
....	Other	85,093.7	84,433.2	96,999.9	42,275.5	51,118.0	11,906.2	14.0
....	Total	99,580.5	102,069.3	124,795.7	53,204.2	66,236.4	25,215.2	25.3

[1] Not elsewhere specified or included.
Source: Official statistics of the U.S. Department of Commerce.

Prior to 2001, Chinese companies chiefly sold parts and components such as monitors;[3] they now, however, increasingly offer downstream products such as computers.

U.S. imports of consumer electronics (except televisions) increased by $1.9 billion (31 percent) to $8.2 billion in 2002, reflecting China's increasingly competitive position in the production and export of consumer electronics worldwide.[4] This increased competitiveness can be attributed in part to consumer electronics companies based in other Asian countries shifting existing manufacturing assets to China or selecting China as the best location for investing in new production capacity.[5] U.S. imports of telephone apparatus expanded by $1.4 billion (45 percent) in 2002 to $4.7 billion. Many U.S. and European producers of telephone sets and cell phones have established production facilities in China to supply local and international markets.

Even production of simple manufacture products is becoming more sophisticated and technologically based. U.S. imports of furniture from China rose by $1.8 billion (39 percent) to $6.4 billion in 2002. Furniture producers in China, already highly competitive with low labor costs, have developed some state-of-the-art production facilities[6] and in some instances, partnered with U.S. furniture companies to complement U.S. production (e.g., stackable, knock-down furniture, as well as wood furniture and parts) or to supply labor-intensive parts (such as lathed table and chair legs).

U.S. imports of games (mostly video games) from China nearly doubled in 2002, rising by $1.1 billion to $2.7 billion. Most of the increase was accounted for by the shift in production of video game consoles from Japan to China. U.S. imports of such consoles from China grew by $1.1 billion, while U.S. imports from Japan fell by $1.2 billion. The three dominant producers of video game consoles worldwide (two based in Japan and one based in the United States with assembly in Mexico) were engaged in intense competition in 2002, leading one producer in Japan to seek a price advantage by shifting production to China.[7]

Table 3. U.S. imports from China: changing relative shares by sector, 1990, 1996, 2002

HTS		Share of total imports from China			Change in share
		1990	1996	2000	1990–2002
	Increasing Shares.				
84	Non-electrical machinery	3.1%	8.7%	16.2%	13.1%
85	Electrical machinery	12.6%	17.1%	19.4%	6.9%
94	Furniture and bedding	1.8%	4.7%	8.0%	6.1%
90	Precision instruments	1.0%	2.9%	2.2%	1.2%
	Decreasing Shares.				
62	Non-knit apparel	13.8%	6.9%	3.6%	-10.2%
61	Knit Apparel	7.1%	2.9%	2.1%	-5.0%
27	Mineral fuels	4.4%	0.9%	0.3%	-4.1%

[3] "CBQ Confirms Plans to Import Computers from China Products to Include Personal Computers, Notebook Computers, and Handheld Devices," *Business Wire,* Aug. 16, 2001.

[4] The consumer electronics category includes articles such as radios, tape-recorders, loudspeakers, and magnetic heads.

[5] One-fifth of Japan's production of consumer electronics has reportedly been shifted to China. Japanese companies that have moved a considerable share of their manufacturing assets to China include NEC and Matsushita. "Chinese Exports: Japan's Phantom Menace," *Business Week Online,* found at *http://www.businessweek.com/bwdaily/dnflash/jan2002/nf20022011...*, retrieved Apr. 2, 2003

[6] For additional information, see Josephine Spalding, *Industry and Trade Summary: Furniture and Motor Vehicle Seats,* USITC publication 3382, Jan. 2001.

[7] *Shifts in U.S. Merchandise Trade 2002,* USITC publication NO. 3611, July 2003. p. 3–4.

Table 3. U.S. imports from China: changing relative shares by sector, 1990, 1996, 2002—Continued

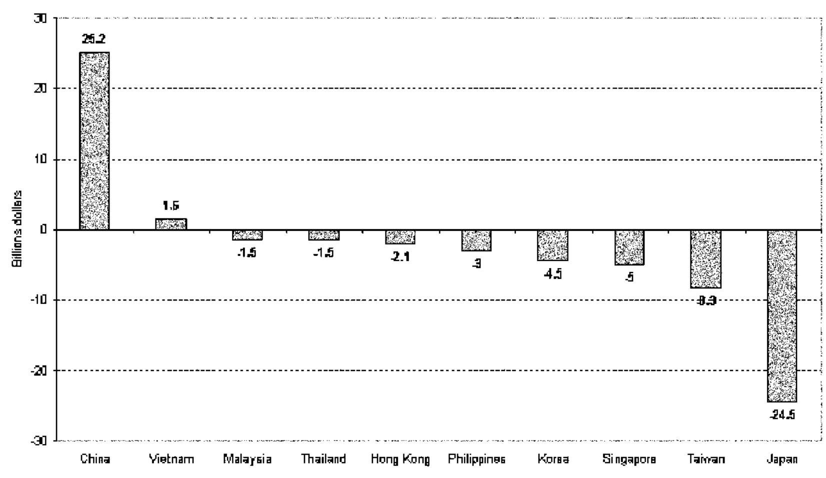
HTS		Share of total imports from China			Change in share
		1990	1996	2000	1990–2002
95	Toys, games, and sports equipment	14.1%	14.7%	11.6%	-2.5%
42	Leather products	5.7%	5.1%	3.6%	-2.1%
3	Fish	2.6%	0.5%	0.5%	-2.1%
64	Footwear	9.8%	12.4%	8.2%	-1.5%
	Other	24.1%	23.2%	24.4%	0.3%
	Total	100.0%	100.0%	100.0%	

Source: official statistics of the U.S. Department of Commerce

Import Displacement: Switching to China from the Rest of Asia?

U.S. trade data show that imports from China are increasing, while imports into the United States from almost every other Asian economy have decreased during 2000–2002. Figure 2 highlights the most recent trend. While U.S. imports from China increased $25.2 billion, imports from Japan decreased $24.5 billion. Similarly, U.S. imports from other Asian economies decreased significantly, including Taiwan ($8.3 billion), Singapore ($5.0 billion), Korea ($4.5 billion), Philippines ($3.0 billion), Hong Kong ($2.1 billion), Thailand ($1.5 billion), and Malaysia ($1.5 billion).

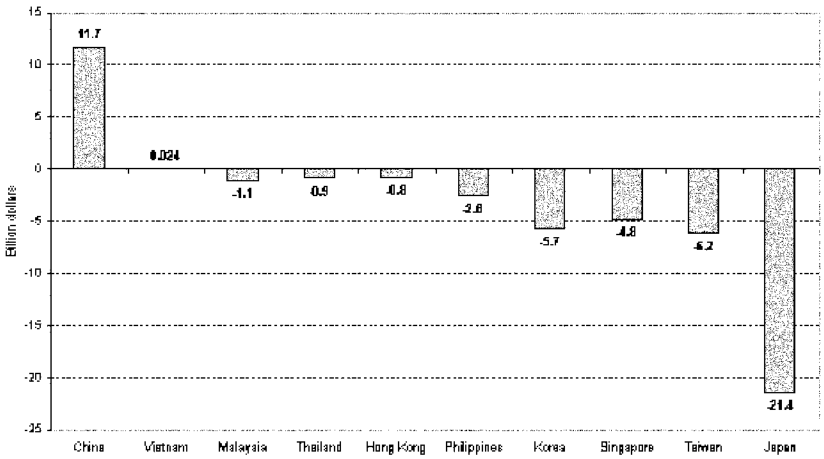
Figure 2
Change in U.S. imports from China and some other Asian trading partners, 2000-2002



Source: Official statistics of the U.S. Department of Commerce.

This trend is especially true for electrical and non-electrical machinery which together constituted 35.6 percent of all U.S. imports from China in 2002 (figure 3). In 1990, China supplied 0.7 percent of U.S. imports of non-electrical machinery and 3.3 percent of electrical machinery. By 2002, these shares had increased to 12.6 percent and 16.1 percent respectively. Most of this increase came at the expense of Japan, whose share of U.S. imports of non-electrical machinery decreased from 29.0 to 15.3 percent and its share of electrical machinery decreased from 32.7 to 13.0 percent during the same period (table 4). While such U.S. imports from China increased $11.7 billion during 2000–2002, imports from other Asian economies significantly decreased, including Japan ($21.4 billion), Philippines ($2.6 billion), Taiwan ($6.2 billion), Singapore ($4.8 billion), Korea ($5.7 billion), and Hong Kong ($0.8 billion).

Figure 3
Change in U.S. imports of electrical and non-electrical machinery from Asia, 2000-2002



Note.-Electrical and non-electrical machinery defined as HTS chapters 84 and 85.
Source: Official statistics of the U.S. Department of Commerce.

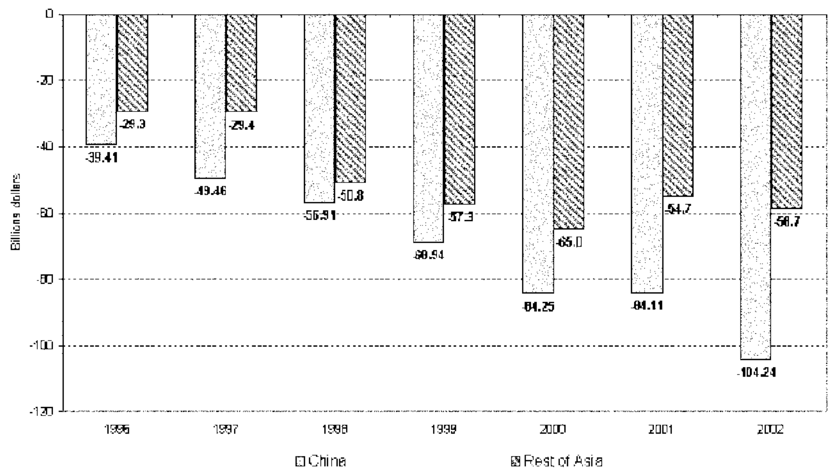
Table 4. U.S. imports of electrical an non-electrical machinery, by source, 1990, 1996, 2002

	1990	1996	2002
Non-electrical Machinery (HTS 84)			
China	0.7%	3.5%	12.6%
Japan	29.0%	22.8%	15.3%
Rest of Pacific Rim	20.2%	29.2%	25.7%
Rest or World	50.1%	44.4%	46.4%
Total	100.0%	100.0%	100.0%
Electrical Machinery (HTS 85)			
China	3.3%	7.7%	16.1%
Japan	32.7%	21.8%	13.0%
Rest of Pacific Rim	30.8%	34.5%	29.0%
Rest or World	33.1%	36.0%	41.9%
Total	100.0%	100.0%	100.0%

Two related explanations for this trend have been offered. First, U.S. importers have switched to Chinese goods due to a significant difference in competitiveness resulting from cheaper prices in China relative to other Asian countries. Second, Asia's smaller economies continue to export to the United States, but indirectly through the Chinese mainland by relocating production into China.

Figure 4 shows the increasing U.S. trade deficit with China during 1996–2002 and the shrinking trade deficit with the rest of Asia during the 2000–2002 period.

Figure 4
U.S. trade deficit with China and with the rest of Asia, 1996-2002



Note.-Rest of Asia includes Hong Kong, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, and Vietnam.
Source: Official statistics of the U.S. Department of Commerce.

China as an Export Market

In contrast to a downward trend for U.S. exports worldwide, U.S. exports to China increased to $20 billion (14 percent) in 2002 (table 5). Much of the increase can be attributed to China's WTO accession in 2001,[8] which has resulted in, according to industry sources, more trade going directly from the United States to China rather than transiting through Hong Kong. Some have compared China today to Japan of the 1970s and early 1980s, when Japan led regional economic growth in Asia. As the largest country in Asia, and the fastest growing economy, China has become a vitally important export market as well as an important source for many of Asia's economies.

Table 5. Leading changes in U.S. exports to China, 2001 and 2002

Sector/commodity	2001	2002	Absolute	Change, 2002 from 2001 Percent
	-----*Million dollars*-----			
U.S. Exports:				
Increases:				
Aircraft, spacecraft, and related equipment (ET013)	2,429	3,367	938	38.6
Semiconductors and integrated circuits (ET033)	946	1,238	291	30.8
Fertilizers (CH016)	420	671	250	59.5
Semiconductor manufacturing machinery (MM087A)	338	551	213	63.1

[8] China's WTO accession has led to decreased tariffs and lower non-tariff barriers. John N. Paden, "The World Trade Organization and Rule-of-Law in China: A First-Year Assessment," *Virginia State Bar Journal,* Spring 2003.

Table 5. Leading changes in U.S. exports to China, 2001 and 2002—Continued

Sector/commodity	2001	2002	Absolute	Change, 2002 from 2001 Percent
Decreases:				
Computers, peripherals, and parts (ET035)	1,209	892	-317	-26.2
All other	12,617	13,835	1,218	9.7
Total	17,959	20,553	2,594	14.4

Note.—Calculations based on unrounded data.
Source: Compiled from official statistics of the U.S. Department of Commerce.

The largest increase in U.S. exports to China from 2001 to 2002 was in aircraft, spacecraft, and related equipment (hereafter aircraft equipment) (table 5), which rose to $3.4 billion, reflecting China's continuing effort to expand its civil aviation fleet to service growing demand [9] and its reliance on Boeing as a supplier. Boeing aircraft accounted for 72 percent of China's fleet of large (over 100 seats) jet aircraft.[10] In addition, a reduction in average Chinese tariffs from 10.5 percent to 7.2 percent from 2001 to 2002 on civil aircraft and related parts has likely stimulated U.S. exports.[11]

U.S. exports of semiconductors and integrated circuits to China continued to grow in 2002, rising by $291 million (31 percent) to $1.2 billion. This increase is attributed to China's rapidly growing demand for these products in the manufacture of telecommunication equipment, computer hardware, and consumer electronics.[12] According to industry observers, about 95 percent of China's semiconductor demand is currently met by imports [13] because of difficulties related to protecting intellectual property rights and creating wholly owned foreign ventures. These difficulties reportedly create significant barriers to foreign firms wishing to establish semiconductor-manufacturing facilities in China.[14]

However, the Chinese semiconductor industry is expanding. Relaxation in 2002 of Government of Taiwan regulations prohibiting Taiwanese manufacturers from operating semiconductor plants in China contributed to the construction of new facilities in China and a surge in U.S. exports of capital equipment for these plants. The regulations had been established to stem the outflow of critical manufacturing technology from Taiwan.[15] As a result, U.S. exports of semiconductor manufacturing equipment to China rose 63 percent to $551 million.

China has also been developing its own production capacity for computers, peripherals, and parts, spurred on, in part, by increased foreign investment. Investors from Taiwan, the United States, the EU, and Japan have been drawn to China both to reduce manufacturing costs and to supply the emerging domestic market in China. Manufacturers in China often have the advantage of a larger supplier base, lower energy costs, and tax incentives, in addition to lower cost labor.[16] This growth

[9] Factors contributing to this growth are the country's vast territory, rapid growth in hard currency tourism, expansion in air cargo volumes, and an increasingly affluent local population. U.S. & Foreign Commercial Service, U.S. Department of Commerce, "Aircraft, Air Traffic Control & Ground Support Equipment, *International Market Insights,* 2002.

[10] Boeing Co., found at *http://www.boeing.com/companyoffices/aboutus/boechina.html#fleet,* retrieved Apr. 23, 2002.

[11] Department of Commerce, "Civil Aircraft," found at *http://www.mac.doc.gov/China/Docs/industryfactsheets/civair.htm,* retrieved on Mar. 28, 2003.

[12] U.S. producer Conexant Systems, for example, increased its supply of specialized semiconductors for communications applications to Legend Groups Ltd., a prominent Chinese computer company, in 2002. "Conexant V.92 Modems Now Shipping in Legend Computers, China's Premier PC Manufacturer; Customized V.92 Feature Development Support by Conexant Shanghai," *Business Wire,* Mar. 5, 2002.

[13] Editor, "A Wafer-Thin Argument: The Market and a High-Tech Dispute," *The Economist,* Apr. 13, 2002.

[14] U.S. Department of Commerce, "Semiconductors and Software," found at *http://www.buyusa.gov/china/en/semiconductors.html,* retrieved on Mar. 27, 2003.

[15] "The Greater China High-Tech Highway," *The McKinsey Quarterly,* 2002, No. 4, found at *http://www.forbes.com/2002/10/11/1011mckinsey.html,* retrieved May 7, 2003.

[16] Ralph Watkins, "Mexico Versus China: Factors Affecting Export and Investment Competition," *Industry Trade and Technology Review,* U.S. International Trade Commission, USITC publication 3534, July 2002, p. 19.

of the Chinese computer industry resulted in a decline in U.S. exports to China of computers, peripherals, and parts of $317 million, or 26 percent, in 2002.

Two aspects of China's export growth are: (1) the record inflows of foreign direct investment into the mainland; and (2) the amount of exports from China generated by foreign firms. International investors, particularly from other parts of Asia, invest in the mainland to take advantage of abundant labor, low wages, and growing infrastructure. A result of this investment is that in 2001, for the first time, over half of China's exports sold in international markets-about $275.0 billion-were produced by firms with foreign investment, either joint ventures or wholly-owned foreign companies.[17]

China's rapid economic growth, rapid growth in trade, and investment inflow have resulted in China becoming a global center for low-cost manufacturing-not only for labor intensive products like apparel, toys, and shoes, but increasingly for electronics, machinery, and information technology. China has become the third largest producer of information technology hardware, and about half of this output in the Chinese mainland is being produced by Taiwanese companies.[18]

Mr. CRANE. Thank you for your testimony. I would like to throw a question out to any and all of you, and anyone who wishes to comment on it, please do.

There are various bills introduced in Congress that condemn China for its trade surplus to the United States and its policy affixing its currency to the U.S. dollar, and which seek to apply sanctions in the form of higher tariffs against Chinese-made goods. Will these measures result in a decline in the overall U.S. trade deficit, and will they increase U.S. manufacturing jobs?

Dr. HOLTZ-EAKIN. Well, Mr. Chairman, as we made an attempt to detail in a fair amount at length in our written testimony, it is the case that the determinants of the U.S. current-account deficit are in large part domestic in character. That reflects not only the exchange rate between the United States and China, but also the pattern of saving, the opportunities for investment, and international capital flows. If one considers the vast array of influences and hones in on those particular policies and their impact on one exchange rate, it is unlikely that policies directed at the dollar/yuan exchange rate will have any significant effect on the U.S. current-account deficit. For the same reason, in our analysis, we walked through the potential sources of the decline in manufacturing employment and tried to isolate the component that might plausibly be related to Chinese trade in particular. It is difficult to make a very compelling empirical case that that is a big influence, and for that reason, changing simply the relative price of the currency would have a minimal effect on U.S. manufacturing employment and would likely be temporary at best.

Mr. CRANE. As is often the case, we are trying to isolate the different causes in our decrease in jobs, especially manufacturing jobs, in the past several years. People become very focused on some causes to the exclusion of others. What are the top causes of manufacturing job losses, and where does trade fall, and specifically trade with China, in this?

Dr. HOLTZ-EAKIN. I could say a couple of things. I think you can point to about five factors that have contributed to the overall

[17] Nicholas Lardy, "The Economic Future of China," speech to the Asia Society, Houston, Apr. 19, 2002. Found at Internet address: *http://www.asiasociety.org,* retrieved Aug. 22, 2003.

[18] See USITC, *U.S.-Taiwan-FTA: Likely Economic Impact of a Free Trade Agreement Between the United States and Taiwan,* publication 3548, October 2002, p. 2–5.

decline in manufacturing employment. There has been a long-term shift in the composition of demand in the United States away from goods and toward services. Combined with a secular (long term) pattern of productivity improvements that have lowered the relative price of manufactured goods, that shift has permitted consumers to spend more on services and devote less of their budgets to manufacturing, while manufacturers have continued to produce a lot of output. That productivity growth has allowed them to do it with fewer labor inputs, and as a result, we have seen a longstanding trend toward less employment in manufacturing, even though manufacturing output has held up quite well.

The trend in less manufacturing employment has been amplified by some measurement issues. Many workers that were previously counted as part of the manufacturing labor force are now counted in temporary help services and other components of the labor force. More recently, there has been a fairly dramatic impact of the business cycle. One feature of that business cycle that stands out is that the cycle is more coordinated with those of our trading partners. We see the U.S. economy and other major trading partners' economies going down at the same time; and, as a result, given the importance of manufacturing exports in the United States and of those countries as markets for exports, we have seen much weaker export growth in this recession and recovery than we see in a typical recession and recovery. That stands out as a very interesting trade-related component of this recession that has been exacerbated by strong productivity growth.

So, if you go down these four components—the secular trend in composition of demand, the productivity improvements, the measurement issues, and then the business cycle—only after you go through those four will you get to a component that would be trade, or China-specific trade.

Mr. CRANE. Thank you. Mr. Levin.

Mr. LEVIN. I very much appreciate the professionalism of all of you. I think the attempt to just make trade issues de minimis only feeds into those who want to make it de maximis. For example, let us take apparel and textile, Dr. Holtz-Eakin. Hasn't trade been relevant to that dynamic, to the loss of jobs?

Dr. HOLTZ-EAKIN. I think that in apparel and textiles, there have been conscious policy efforts on the part of the United States to open its markets, and that has increased competition. That stands out in our report as one of those areas where, in fact, the employment decline has been most dramatic. It is not typical, however, of the overall manufacturing sector.

Mr. LEVIN. By kind of resisting disaggregation, you paint a picture that isn't believable to those who have been affected, and it doesn't help us address the issues. For example, let me just ask you about currency in China. Do you have any doubt that the way the Japanese have handled currency valuations has had some significant impact on manufacturing in the United States?

Dr. HOLTZ-EAKIN. Japan or China?

Mr. LEVIN. Japan. Not you. Any of the three of you. Dr. Yager—either or all of you. Is there any doubt that that has been one of the factors?

Dr. HOLTZ-EAKIN. As a broad statement of the impact of the dollar/yen or dollar/euro exchange rate, there has been a tremendous amount of tension placed on those particular——

Mr. LEVIN. I mean over the last 10 years. Was there any doubt that Japan was controlling currency valuations and was determined to have a strong export platform in the automobile sector? Is there any doubt about that?

Dr. HOLTZ-EAKIN. I think there is little doubt that there have been active attempts by many governments—including Japan—to manage their exchange rates by using different policies. Let us stipulate that.

The larger point is that in tracing the impact of those policies on the U.S. labor force and employment, there are several steps. The exchange rate is not the only determinant of trade. It will be one component. The price-adjusted real exchange rate will be more important, and it is difficult even when attempting to manage a nominal exchange rate to manage the real exchange rate. Inflation is one of the consequences of trying to keep your currency low. Finally, it is the absence of domestic demand growth in those countries. I would say that the disappointing domestic demand growth in Japan and Europe, which has led them to focus so much on export growth, had a big influence on our ability to export to those markets. Those are all empirical adjustments.

Mr. LEVIN. Japan wasn't in that position 10 or 15 years ago, and a car that sold for $35,000 here, the same car sold for $50,000 in equivalent yen.

I think it is a mistake to just cast aside trade issues as having an impact on the dynamics within the U.S. economy. What you tend to do—your comments about the—your comments, for example, it is shifting a bit. Dr. Yager, your comments about the WTO compliance is—it is so gentle. We worked hard to get an annual review. As you know, it was one of the three pillars of our legislation, and we really kept the heat on the Administration to get it, and it hasn't worked well. It is critical that it work well, and I think kind of going soft, which you don't always do, isn't going to propel the Administration to really be active vigorously in making that process work.

Dr. YAGER. Mr. Levin, as a matter of fact, we are doing another round of the work that we did to oversee compliance, and as you know, in the report that we did in March of this year, one of the two case studies that we looked into was the TRM. In our report we did talk about the frustrations and the disappointments that the United States had in trying to get progress through that mechanism. We are observing that, and we will be traveling to Geneva to look again to see whether that process is being used effectively by the U.S. agencies, because we do recognize that this is one of those important avenues to try to get change in China. As we say in our testimony, we really think that pressure from the Congress, pressure from the executive branch, from the business community and from the WTO is necessary to try to get these fundamental changes in the Chinese system.

Mr. LEVIN. Thank you.

Mr. CRANE. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman, and thank you, gentlemen, for being here. I missed some of your testimony, Dr. Holtz-Eakin, and therefore I may have missed the thrust of it, but let me try to feed back what I heard. I heard from you gentlemen that tariffs won't work; revaluation of the yuan really isn't going to work; that a good part of the blame of this terrific imbalance is really in terms of foreigners putting money in there and exporting back here. So, the question is what is the answer? Here we are. We are dealing with this, and if you take a look at the chart, Dr. Holtz-Eakin, that you had on one of the pages in here, it is pretty scary in terms of the increase and the—here it is, on page 18, from 1989 to 2002. You all know this. This is nothing new, but we don't want to do stupid things. We want to try to reflect what is economically sound, yet at the same time we have a different role here where each of us are responsible for about 700,000 people, and how do you answer something like this? You just can't answer by saying U.S. companies are reinvesting, and we shouldn't put tariffs. We have got to have some answers to this.

It seems to me that one of the basic concepts of international trade is not to beggar thy neighbor. We are getting into a situation that is very serious, and the thing that I worry about long term is if we don't get our deficit down, we continue to be mining these current-account deficits, and there is a sort of a worry about the value of the dollar as a secondary or reserve currency, these types of things are going to come home to roost. We are going to have logical reasons for being there, but we don't have any solutions. You got to help us along the way, and I don't see that in your testimony. Maybe you could help.

Dr. ROGOWSKY. You lay out a remarkably difficult job, because in trade liberalization there will be winners, and there will be losers, and how do you explain to the losers what has happened, and what cure there might be? What we find, and I think these gentlemen will agree, is that there are forces that take place that liberalization opens up. How an economy responds to those forces is a slow process. It is a difficult process to teach.

You have heard lots of numbers today about the successes with China. Exports are growing. In fact, it is a fairly open economy relative to Brazil, India and some of our other trading partners, but liberalization is a very slow process. It is clear that a lot of investment is going into China. A lot of it is American investment. A lot of it is Japanese and Taiwanese and European. So, there is a shifting take taking place as China relies on its comparative advantage, which it is able to get into light manufacturing very effectively.

Mr. HOUGHTON. Could I interrupt a minute, because our time is going to run out, and other people want to ask questions. I know it is going to be a slow process, and we don't want to have a knee-jerk reaction. What is the first step? What do we do? What do we do?

Dr. YAGER. One of the things that we worked on with your Committee for some time was trade adjustment assistance. Certainly there are people—losers—or people dislocated by trade, and I think some of the things that this Committee did with the trade adjustment assistance makes it easier for some of those people to get retrained and move into a new job. Now, the other thing——

Mr. HOUGHTON. Could I interrupt a minute? So, in effect you are saying that—I am going to put words in your mouth, and correct me—that the trend is going to continue, and one of the things we got to do is to retrain our people for other jobs. Is that the answer?

Dr. YAGER. I think that is one of the components, that some of those people can be retrained for new jobs.

Mr. HOUGHTON. From other jobs which will go in the way of the first jobs.

Dr. YAGER. There is a lot of dislocation in certain sectors. When we did our trade adjustment assistance work, it clearly was the textile industry that was the one who was losing the most jobs—and we understand, as we pointed out in our reports, that some of the people who were working in those textile plants are difficult to retrain and find new jobs because they may be in a plant in a rural area.

Mr. HOUGHTON. Okay. So, we retrain people. What else do we do? We are talking about exchange of goods, not necessarily retraining people for other jobs.

Dr. YAGER. The other component that you can do and I think this Committee has been doing has been trying to ensure that the market for U.S. exports is open. So, ensuring that China complies with its commitments, whether it is in the agricultural area or in high-tech sectors, to ensure that that market is open so that the United States can produce those goods that it is most competitive at producing. That is the way we get to a higher standard of living, and it could be through productivity growth and exports, and making sure those markets are open for U.S. goods is an important component of it as well.

Mr. CRANE. Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman, and thank you to the panelists for their testimony. If I could continue on the questioning that just occurred. Dr. Yager, let me make sure I heard you correctly. Retraining and creative adjustment assistance, assistance to those employees, workers who are dislocated, may be one of the ultimate answers we have for the trade dislocation that occurs. I heard you say that, right?

Dr. YAGER. I think that is one component of a policy, yes.

Mr. BECERRA. This is my 11th year. I have never seen a retraining program that has ever left an American worker who has lost a job in the manufacturing field and had to be retrained as a result of trade dislocation ever get another job that has paid him or her at least the wage that he or she had in that manufacturing sector. Can you name any workers who have been retrained and are earning more money than they had before they lost their manufacturing jobs?

Dr. YAGER. One of the things that we observed with those people who lost work and then came back into the workforce, there was a generally lower wage paid to those people upon reentry. Some of that lower wage was due to the fact that they were new in a firm or industry, and some people were able to make up that difference in their new occupation, but they do start off at a lower wage level.

Mr. BECERRA. Right now we are continuing to lose manufacturing jobs, and we have lost 2.5 million manufacturing jobs in the last 3 years. That is the quote I have been using. I looked at Dr. Holtz-Eakin's numbers, and it is 2.8 million jobs in the last 3 years. So, 300,000 additional jobs lost in manufacturing over the last 3 years. Where are these folks going to work?

By the way, we are losing jobs not just in typical industrial manufacturing, but in the technology field as well. In fact, I think it is Dr. Holtz-Eakin's testimony or someone's testimony that we are losing perhaps more jobs in that segment of our economy than in other areas where we would think the industrial base would lose these jobs.

So, I think it is real pie in the sky to believe that American workers should trust that they will have an opportunity to get a decent-paying job should they lose their job today because of trade dislocation. Because of that, I hope that we all will leave here looking for ways to truly pressure, as I believe Dr. Yager said, to pressure the Chinese. Whether it is the Administration or Congress, we have to use whatever tools we can, and we have to do it in ways that are rational. I am not saying we go out there and beat them simply because we don't like what they are doing.

Let me ask this: Dr. Holtz-Eakin, you mentioned a little earlier that it is kind of difficult to connect manufacturing job losses with our trade with China. Let me ask this: My understanding is—and, again, these numbers may be a little old. They—the number of job losses may be greater, but my understanding is that in the textile and apparel industry in this country, we have lost in the last 3 years or so some 270,000 jobs. At the same time imports of textiles and apparel from China exceed U.S. imports from all other countries in the world combined. So, China alone sends us more textile and apparel than any other country in the world combined, and we have lost 270,000 jobs in this country.

At the same time, I think I said it earlier to the earlier panel, the average wage of a Chinese worker in northeastern China where they are very industrialized, is about 60 cents an hour. Tell me again that there is no connection between what China pays its workers; the fact that it has grabbed a whole bunch of that apparel and textile product and sending it now to us compared to any other place in the world, and there is no connection?

Dr. HOLTZ-EAKIN. Let me take it in two pieces. First, my statement is about the broad pattern of manufacturing employment, not particular industries or companies. So, I do want to distinguish between those two kinds of assertions. Second, even if you look at just apparel, to look at the Chinese imports in isolation is potentially misleading because it could be the case—and the record suggests that those imports from China displaced other imports from other competitors. So, it may be the case that we would have lost jobs in the apparel industry anyway as a result of trade pressures.

Mr. BECERRA. I agree with you. I think China has displaced Korea or some other country in terms of the country now exporting those textiles to us, but China gets to replace Korea because it is paying 60 cents an hour for its workers, where Korea is paying $2 or $3. We will never get those jobs back because we are never going to return to the days where we pay $2 to $3 to our worker for that type of work and will never compete with those countries if we allow those countries to continue to have labor rates, wage rates that are so low that it will continue to drive American companies abroad to be able to compete as they produce. I thank you for the time.

Mr. CRANE. Mr. English.

Mr. ENGLISH. I thank you, Mr. Chairman, and I would like to spin off, Dr. Holtz-Eakin, on the last gentleman's line of inquiry because I think he raises a very important point. There are clearly some jobs that we are likely in the global economy not to recapture because their placement has largely determined why the labor rates are low because they are naturally labor-intensive. Are there also not a range of manufacturing jobs that are—that are—can be naturally capital-intensive; in other words, where you can have two or three American workers running a highly mechanized, highly computerized production line with a lot of technological value added, and that those manufacturing jobs can be just as easily or more easily produced under competitive advantage here in the United States? Would all the three of you agree with that?

Dr. HOLTZ-EAKIN. I think there is a lot of truth to that. An anecdote that illustrates that is that General Electric (GE) produces the low-value-added parts of its computer-assisted tomography (CT) scans in China, but they then bring them back to the United States and employ 5,000 workers in Wisconsin to do the highly technical, high-productivity part of that job. Both are in manufacturing.

Mr. ENGLISH. That is an excellent example because GE, their locomotive division is my largest employer, and we make locomotive kits for export that are exported globally.

The problem I have here is that are we not talking about a China that has a set of—I think the term "mercantilist" is not overstating—trade policies that discourages imports, discourages even bringing in en masse things that we can manufacture more effectively than they can if the natural terms of trade are level. The thing that I am frankly concerned about is that—this currency issue is maybe the best example, and we have had an interesting debate on it today. Manipulating the currency is one way that a country can dictate for itself a significant price advantage. We can debate how much China does it and how much it has actually been done, but I wonder if we aren't—unless we insist on a level playing field at least on issues that are important relative to the WTO, if we don't insist on an adherence to WTO rules, aren't we in effect ceding some manufacturing sectors that more naturally are located in the United States to countries that are determined—that beggar their own consumers and maintain substantial disparities? Is that an unfair analysis, or am I missing something?

Dr. HOLTZ-EAKIN. I will leave that to my colleagues who are more knowledgeable than I am about product-specific barriers to sales in China. Again, all you can offer is empirical magnitudes in the record, and the first is that China's real exchange rate adjusted for prices has not dramatically changed over time, and as a result, there doesn't appear to be any recent innovation in its relative real terms of trade that would be important.

Mr. ENGLISH. Let me, because I have limited time. I don't understand why that would be significant, because China, after all, has been given an opportunity for many years to manipulate its exchange rate. The fact that it has manipulated it to the same degree and in the same way for a period of years does not really detract from the fact that they have manipulated it relative to where the market would land it. We can debate about where the market would actually drive the exchange rate, but I think the fact that this is a longstanding practice of theirs and not an innovation doesn't really make that very significant.

Dr. HOLTZ-EAKIN. That is true going back. Going forward, there is broad consensus on two things. China should move to a more flexible exchange rate policy and is quite likely to. What is open to speculation, and perhaps policy intervention, is the transition path and how quickly they will open capital markets in the face of their acknowledged weakness in the banking sector. How quickly they will float the yuan is something that really is on the radar screen.

Mr. ENGLISH. I appreciate, by the way, the testimony, and I know I am out of time. Dr. Rogowsky, I would like to ask you questions about why you think China's economy is relatively open relative to some of other trading partners. That certainly hasn't been the finding of some of our local manufacturers, but perhaps we can have that exchange.

Again, I want to thank all of you for the excellence of your testimony, which is far more nuanced than what we have heard from many other sources, so I thank you for it.

Mr. CRANE. Ms. Tubbs Jones.

Ms. TUBBS JONES. Gentlemen, thank you for having dinner with us. The appetizer may not have been so good, but we are glad to have you.

My concern is to be able to speak to the 645,000 people that I represent in northeast Ohio and to make it plain, you understand what I am saying. Make it plain to them why we have lost manufacturing jobs in the United States, and why the argument that China's boosting of opportunities for jobs, be it in manufacturing, apparel, whatever the heck it is, is not the reason we are struggling like we are.

Now, Dr. Holtz-Eakin went through one, two, three, and four reasons why, and I lost where I wrote them down, but none of them—what was long-term shift in demand, secular pattern of productivity, measuring issues, et cetera, et cetera, which everyday people—duh, make it plain in a real short sentence how you do not connect the jobs, in our opinion, going to China and us not having jobs in the United States.

Dr. HOLTZ-EAKIN. Sometimes you don't have enough customers, and one way that happens is that even within the United States, people shift from buying manufacturing products to other things. In the absence of customers, it is hard to make a business go and to hire people. That is a non-trade thing that is a U.S. phenomenon.

Ms. TUBBS JONES. The reason you don't have customers anymore—and I will give you an example. Central Brass in my district that makes facets says, I don't have any customers because they make what I make here cheaper in China, so they are doing what I used to do in the United States in China.

Dr. HOLTZ-EAKIN. No. My first factor is simply shifts in the composition of demand in the United States. People choose to buy more services and fewer manufacturing goods than they did in the past, and if your customers choose to buy something else, it is harder to keep employment.

Ms. TUBBS JONES. You are saying that people in the United States are buying more services, and so people in manufacturing jobs have no jobs because we are all buying services instead of buying product?

Dr. HOLTZ-EAKIN. They are shifting to services, and as a result, there are fewer jobs in manufacturing.

Ms. TUBBS JONES. I have to leave you alone for a moment because I want to talk to Dr. Rogowsky. Dr. Rogowsky, I testified at the USITC on the issue of steel. In other countries it appears that there is a policy that allows steel companies to be successful, and I mean a broad policy that includes more than just the tariff piece. What do you think we ought to have, or what should be an additional policy that would help steel in the country? I am for tariffs because we got to start somewhere. What else we ought to be doing to help undergird the steel industry in the United States? If you can't answer that question because it is a policy question, I will just keep cross-examining you anyway. Go ahead.

Dr. ROGOWSKY. I will try to keep it confined to the parameters that I think I can touch on. The steel industry in the United States, like steel industry in every country, is problematic. Partly it is because steel all over the world has been an industry that is considered to be infrastructure to development. So, there has been lots of subsidies and lots of protection and lots of help.

Ms. TUBBS JONES. In other countries other than ours.

Dr. ROGOWSKY. In other countries and here. As a result, there is massive overcapacity in the world. All the countries and all the producers are facing this problem. So, there is an effort, as you know—the United States is leading this, and it is being conducted in part at the Organization for Economic Cooperation and Development—to try and negotiate some way of handling this large overcapacity problem.

Given that overcapacity, what do you do in the United States? I think in the United States you try to take an industry like this and help it modernize to the extent it can and help it try to come up to the levels of technological productivity that allows it to compete in the world marketplace.

Ms. TUBBS JONES. Real quick. Dr. Yager, GE produces something in China, it brings it back to the United States to assemble, and do you think this recent tax proposal that supports development—manufacturing in foreign countries, provides a tax incentive continues to allow GE to have a better product or cheaper product by doing it there?

Dr. YAGER. I have to admit, Ms. Tubbs Jones, I am not familiar with it. I did not provide the GE example.

Ms. TUBBS JONES. Might you think of answering that question and answering me at a later date?

Mr. CRANE. Thank you. I want to thank our panelists. We appreciate your patience, and we appreciate your input. We look forward to continuing to work with you as we proceed down this path. With that, our Committee, with the break here for three more votes now, stands in recess.

[Whereupon, at 6:30 p.m., the hearing was recessed, to reconvene on Friday, October 31, 2003, at 9:00 a.m.]

UNITED STATES-CHINA ECONOMIC RELATIONS AND CHINA'S ROLE IN THE GLOBAL ECONOMY

FRIDAY, OCTOBER 31, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 9:03 a.m., in room 1100, Longworth House Office Building, Hon. Rob Portman presiding.

Mr. PORTMAN. Well, good morning. Let's get started. The witnesses are here. We will try to get started promptly.

We do not have any votes scheduled today. That was not the case earlier in the week. For that reason, there may not be as many Members here before you, but, as you know, all your testimony will be made part of the record, and the important people are here, which is the staff, and again we do appreciate your being here.

We had a good day of testimony yesterday. We heard from the Department of the Treasury, we heard from USTR, we heard from Council of Economic Advisers at the White House, we heard from CBO, GAO, and the USITC. We were able to discuss important issues with regard to our relations with China on an economic basis, including the impact of Chinese currency and its peg to the U.S. dollar.

We also learned more about China's WTO accession commitments and whether those had been met, or not, and finally just discussion about China and trade, with a particular focus on U.S. manufacturing.

We also had some interesting discussion yesterday about U.S. competitiveness generally and how that related to our economic relationship with China and, for that matter, with the rest of the global competitors.

This morning, we are pleased to have with us a distinguished panel of private sector representatives. I will introduce the panel and then ask them to each speak within the 5-minute allotment to leave us plenty of time for questions.

At the end of the introductions, we will have testimony begin; and then before Mr. Kruse testifies I would like to have Representative Hulshof to give you a further introduction. You are one of his valued constituents, if you would like to do so.

First we will hear from Douglas DeVos, who is President and Co-Chief Executive Officer (CEO) of Alticor, Inc., of Ada, Michigan; and, Mr. DeVos, appreciate your being here with us today to talk about some of the manufacturing issues. David Malpass is here, who is the Chief Global Economist and Senior Managing Director of Bear, Stearns and Company in New York. We have James Jarrett here, who is Vice President, Legal and Government Affairs and Director of Worldwide Government Affairs for Intel Corporation in Santa Clara, California. Malcolm O'Hagan is here, who is President of the National Electrical Manufacturers Association (NEMA), from Rosslyn, Virginia, representing people from all around the country. Charles Kruse, as I said, is a farmer from Missouri and President of the Missouri Farm Bureau in Dexter, Missouri; and, finally, Joseph Papovich, who is Senior Vice President International of the Recording Industry Association of America.

Again, gentlemen, glad to have you here. Mr. DeVos, if you would please proceed.

Ms. TUBBS JONES. I did not get a chance to say anything.

Mr. PORTMAN. Oh, I am sorry. This is an all-Ohio hearing this morning. My colleague, Ms. Stephanie Tubbs Jones from Cleveland, Ohio, is here with me this morning; and I would like to have her give a brief opening statement.

Ms. TUBBS JONES. Thank you, Mr. Chairman. It is not often that two Ohioans have the opportunity to sit next to each other, and it is really not often that, as a brand new Member of the Committee on Ways and Means, I get to sit in the Ranking Member's chair, so I am loving it. I would like to welcome all of you to this hearing this morning and look forward to some of your comments.

Although China is home to one of the most ancient civilizations, because of increasing trade with the United States and globalization the everyday life of the Chinese citizen is a lot like that of the average American citizen, though the income of most Chinese is far below that of most American workers.

The Chinese communicate using many of the same devices as we do. The Chinese eat many of the same fast-food and serve many Americans and enjoy many of the same forms of entertainment, but our two countries also have many differences, which bring us to this hearing held yesterday and today.

In order to maintain success in our future trade and economic relationships, the United States must continue to keep its market doors open, but China must begin to be more expeditious in opening up a market-based economy. It appears to me that the United States is on the wrong end of the trading spectrum with China.

In today's market, the yuan is undervalued by as much as 15 to 40 percent in comparison with the dollar.

Where does the problem exist? The problem comes into place when the United States exports goods to China and is required to pay more money in shipping, taxes, and fees because of China's lack of a market-based economy, while the Chinese businesses pay far less to ship goods to the United States. As a result, Chinese manufacturers can compete with the prices of U.S. manufacturers, but, because of the exportation costs which U.S. businesses must face, U.S. businesses lose an advantage in selling overseas.

All this macroeconomic theory may get lost on some of us until we return to our Congressional District, particularly in the Congressional District of Ohio. In the last—since 2001, we have lost more than 150,000 jobs. In my Congressional District itself, we lost more than 50,000 jobs; and my constituents want to know where are the jobs going, why are we losing our health care and other benefits.

I hope that those of you in the private sector might be able to shed some light on some of the questions that my constituents have, as well as some of the questions we asked of the Administration in the past day.

I am pleased to have the panel present to us today, and I look forward to your comments. I thank the Chairman for the opportunity to give my opening statement.

[The opening statement of Ms. Tubbs Jones follows:]

Opening Statement of the Honorable Stephanie Tubbs Jones, a Representative in Congress from the State of Ohio

Although China is home to one of the world's most ancient and complicated civilizations, because of increasing trade with the U.S. and globalization, the everyday life of a Chinese is a lot like the life of an American. The Chinese communicate via the same devices Americans communicate by. People communicate by cell phones, e-mail and faxes. The Chinese also eat at many of the same fast-food chains that serve many Americans, and enjoy many of the same forms of entertainment.

With that being said, it is with great intention that I strive to protect the quality of life sharing and the economic relationship that exist between the two countries.

In order to maintain success in our future trade and economic relationships, the U.S. must continue to keep its market doors open and China must begin to move more expeditiously in opening up a market based economy.

It appears to me that the U.S. is on the wrong end of the trading spectrum with China. In today's market, the *yuan* is undervalued by as much as 15 to 40 percent in comparison to the dollar. Where does the problem exist? The problem comes into place when the U.S. export goods to China and are required to pay more money in shipping, taxes and fees because of the lack of a China's market based economy, while the Chinese businesses pay far less to ship goods to the U.S.

As a result, Chinese manufactures can compete with the prices of U.S. manufactures, but because of the exportation cost, which U.S. businesses must face, U.S. businesses lose interest in selling overseas.

In addition, there is another reason why establishing a Chinese market based economy will be extremely vital in helping the U.S. manufacturing industries rebound. As the U.S. economy continues to struggle, U.S. manufacturing jobs are continuing to be lost. Now what role does the Chinese exporters play in this equation? Well . . . I think that question has already been answered, the real question is what is the role Will the Chinese exporters play in the manufacturing industry rebound?

With the speedy production of goods in China and no place for the products to go, there have been talks by Chinese manufacturers on grossly lowering the prices of the products and exporting the products. So, not only will the exportation fees be less, but the overall cost of the product will be too.

By having this expert panel here today, I hope that the answers that I have heard from outside sources, will not be the same answer that this panel, that is assembled here will recite.

Mr. PORTMAN. Thank you, Ms. Tubbs Jones. We appreciate your statement. Would any other Members like to make an opening statement? Mr. DeVos.

STATEMENT OF DOUGLAS L. DEVOS, PRESIDENT, ALTICOR, INC., ADA, MICHIGAN

Mr. DEVOS. Good morning, Mr. Chairman and Members of the Committee. My name is, Doug DeVos. I am honored to be here with you.

I am the President of Alticor, Incorporated, the parent company of Amway Corporation, which is a global direct selling company, Quixtar, Incorporated, which is an E-commerce business operating in North America, and the Access Business Group, which is a manufacturing and logistics services company, based in Ada, Michigan.

We are happy to be here to talk a little bit today about one of our fastest-growing affiliates and strongest, Amway (China). I know we have submitted written testimony to the record already, so I will try not to dig into too much of that. I am sure you have already had that and reviewed it, but there are two points I would love to touch base on.

First of all, Alticor is an organization that does export to China and would love to be able to export more in the future. In fact, today in the Wall Street Journal, coming in here, it says, China is also the world's fastest-growing export market. In an otherwise flat year for American exports, U.S. shipments to China are up more than 20 percent. Again, a lot of facts in a very complex situation.

Second, there are things that we can do here at home to fiscal policy that you and this Committee and Members of Congress can do to help us become more competitive.

By way of a little bit more background, Alticor, our revenues are just under $5 billion in our last fiscal year. Eighty percent of our revenues come from outside the United States. China is our largest single affiliate, and their sales there exceed $1 billion at that point. Our exports to China are about a quarter of a billion dollars; and Alticor currently employs about 4,500 people here in the United States, primarily in Michigan and also in California.

Now while China is a great market for us, it is also a challenge. There are certain vulnerabilities that we have faced and continue to face there. Therefore, our actions that are taken here do have an impact not only on us but certainly on other businesses operating in China that could be negative to the business environment there. Therefore, there are a couple things that we would say that aren't necessarily critical from our perspective.

One of them is indeed currency pay. That is not viewed as an issue for us. It is certainly a delicate issue for many. It is an issue that is tied to China's transition from a planned to a market economy, hugely complex, and therefore it doesn't make the list of issues that we deal with.

Also, tariffs. I know sometimes they are considered in trade issues such as this. Our concern is that they begin to become retaliatory and then hurt both sides to create a lose/lose situation. So, our written testimony dives into those in greater detail.

Now, what we can do? There are things we can do, and that is the great part. There is hope for dealing with the issues that we face.

Our country's fiscal policies can have an enormous impact on the competitiveness of businesses here and our ability to compete all over the world. In fact, there has been some international tax rules that you as a Committee have passed. We would urge Congress to take action to reduce the tax burden on American manufacturing companies so they could effectively compete more globally. So, we would urge Congress to move on that because we could use the help, as is stated, right here and right now.

Our key point here is that Congress can do more to create and preserve jobs in the United States by addressing U.S. policy problems than it can to look to others to solve our problems.

Now we know China has some things to do, too. They need to implement their WTO commitments. They need to look forward on those sorts of things. They need to establish trading rights that would enable us as an organization to import more products than we currently do; and, like I say, we like to do that.

Full trading rights would also lead to full distribution rights and therefore not only the ability to import products there but the ability to operate and distribute products in that marketplace.

The last point I would like to raise is the need for ongoing government support in issues such as this. We have been supported well by many U.S. agencies in China and indeed in other parts of the world. The U.S. Department of State, Department of Commerce, and the USTR have been very effective in helping us negotiate challenges that we face as a company; and we have seen them do that with many other organizations as well. Sometimes, as you look at funding for those organizations, I know we tend to try to keep our costs low, as we do in our businesses, but these organizations are very, very effective in following through on the huge level of detail that is required to allow businesses to operate fairly in those markets. Thank you very much.

[The prepared statement of Mr. DeVos follows:]

Statement of Douglas L. DeVos, President, Alticor, Inc., Ada, Michigan

Mr. Chairman, Members of the Committee: I am Doug DeVos, President of Alticor, Inc., the parent company of Amway Corporation, Quixtar and the Access Business Group. I am pleased to be able to speak to you this morning about one of our most successful affiliates, Amway (China) Company Ltd, also known as ACCL. Our company, which is headquartered in Ada, Michigan, is a leading manufacturer of cleaning products, personal care products, cosmetics and nutritional supplements. We use the direct selling method of distribution, which means that we enter into contracts with individuals who own their own businesses selling and marketing these products for us.

Alticor's annual revenues are just under $5 billion per year with almost 80 percent of that total coming from foreign markets. China is currently our largest single market with sales exceeding $1 billion annually. Our exports to China, including services and intellectual property charges, total almost one-quarter of a billion dollars and help to support more than 4500 jobs at our Michigan and California facilities.

I want to stress two points here: We export to China and we hope to export more in the future. While China is a very good market for us, it may also be the most vulnerable and unstable market in which we operate. Any number of actions could ruin our business in China. Speaking from our experiences as a major exporter with a large stake in the Chinese market, I am here today to discuss actions that the US Congress should—and should not—take to help us and other US manufacturers become better exporters to China and to the rest of the world as well.

My presentation is in four sections:

- First, I will discuss the issue of China's currency peg and the more general topic of currency manipulation in some countries;
- Second, I will comment on efforts in Congress to force certain actions on the Chinese government;
- Third, I will outline what I see as the serious commercial and economic issue with regard to China, which is full compliance with the commitments it made in joining the World Trade Organization (WTO);
- Finally, I will focus on those actions that Congress could take that will provide meaningful assistance to US manufacturers.

China's Currency Peg

China has maintained a fixed exchange rate between its currency—the renminbi or RMB—and the US dollar for more than a decade. It held the line on this rate even when the value of other Asian currencies fell dramatically in the late 1990's, during what was called the "Asian financial crisis." In fact, at that time, the US government praised China for not devaluing the RMB in order to protect its share of export markets. The charge of currency manipulation stems from the fact that China has maintained this "peg" while the the value of the US dollar fell. In other words, the Chinese are not guilty of manipulating currency values per se; they are simply following an established policy without regard to changes in US policy.

Yet, the question remains: why does China not permit the RMB to float? The key reason may be that China has not completed the transition from a planned to a market economy. This transition is under way and, in the process, it has become apparent that the banking system is terribly flawed. Banks in China hold huge portfolios of non-performing loans, most of which are to state-owned enterprises that are near bankruptcy. In a rating note published on September 15, Standard & Poor's Corporation said that 45 percent of Chinese loans are non-performing. Ping Chew, an S&P director, is quoted in *Business Week* as saying: "We are afraid the banks will go bankrupt." [i]

Professor Joseph E. Stiglitz, a Nobel laureate in economics, warns that floating the RMB "would lead to a host of further problems, particularly with the country's shaky banking system." [ii] The appreciation of the currency against the dollar could wipe out all export earnings from profitable firms and leave those that are heavily leveraged unable to service any debt. The end result could be a massive economic contraction in China.

In a separate paper, Stiglitz also argues that problems in China "would also cause damage to the world's economy." [iii] China, notwithstanding its image as a major exporter, is also an under-appreciated importer of products and services. Stiglitz notes that there are currently no signs among the internal indicators in China that would point to the need to revalue the RMB and that China barely has an overall trade surplus, a fact that argues against the appreciation of the RMB.

Yet, China has demonstrated a willingness to discuss the exchange-rate issue with the US Government. These talks, we believe, are both appropriate and well timed. We believe that Congress should take no action with regard to China while the Administration works with the Chinese government to find a mutually satisfactory way to address concerns that the RMB is priced at an inappropriate level.

I am not saying that currency manipulation by some countries is not a problem. In fact, we believe that some countries, including several other Asian countries, are following policies that can only be called manipulative. We support efforts by Congress and the Administration to develop the policy tools to address currency manipulation. However, we note that blunt tools are never effective in addressing the delicate problem of exchange rates.

The Dangers of Ill-conceived Tariffs

Of the blunt tools that we believe would harm overall US interests, none is more dangerous than the imposition of tariffs on suspected currency manipulators. Such a move would be counter-productive and do more damage to our economy than anyone could imagine. Simply put, it could be as bad as the Smoot-Hawley Tariff of 1930, which was a response to worldwide overproduction of agriculture after World War I. Although Smoot-Hawley was an effort to help American farmers, it prompted protectionist reactions by countries that imported our manufactured goods.

The retaliation to Smoot-Hawley led to countervailing tariffs in Europe that cut importation of US manufactured goods by 70 percent between 1929 and 1932. Total international trade fell by more than two-thirds during that same period [iv] and contributed to the depth of the economic collapse that we call the "Great Depression."

US participation in the WTO is critically important to all US companies that seek to export products and services. In that 80 percent of Alticor's revenues come from foreign markets, we urge Congress to respect fully US commitments to WTO principles and procedures. We—by that I mean both our company and our country—benefit by the rules-based trading system that the WTO has helped to create. Although the WTO does not now offer a vehicle for dealing with currency manipulation, we strongly oppose taking any action that would violate those principles and thereby leave US exporters vulnerable to WTO-approved sanctions or retaliation.

Instead, we ask that Congress focus on those policies that would facilitate our ability to export. We will explain this, first, with a discussion of China and then with regard to US policies that would enable US companies to export more products abroad.

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[i] *Business Week* through *BusinessWeekonline*: September 29, 2003.

[ii] *The Independent,* through World Sources, Inc., Emerging Markets Data File, October 8, 2003.

[iii] *Agence France Presse,* Shanghai, September 17, 2003, from the *2003 Forbes Global CEO Conference.*

[iv] *Timeline of US History.* http://future.state.gov/future/when/timeline/1921_timeline/smoot_tariff.html.

China's WTO Implementation Effort

In joining the WTO, China agreed to make massive changes to its legal and economic system. According to some estimates, the WTO accession agreement requires the Chinese to change more than 2500 laws and regulations.[v] While we have seen progress in some areas, China must do more to open its market to imported goods and services.

Yet, I believe that China can and should do more to address the problem of market access. I wish I could tell you that China has done its part in this regard. The record on implementation is spotty. The US China Business Council's report on China's WTO implementation published in September warned of several problems regarding protectionism. It went on to say:

> "The inability of government ministries in China to reach policy consensus, and the enactment of questionable policies for the apparent purpose of protecting domestic interests, have slowed the pace of implementation and emerged as serious problems."[vi]

One area stressed by the Council is particularly important to our company. We established ACCL and entered China prior to the signing of the WTO accession agreement. As a consequence, we are hampered by the fact that the foreign investment license limits our business to products that we manufacture in China. We can use US raw materials and can test-market other products, but only for a limited time. One of the critically important WTO commitments is to grant all companies operating in China full "trading rights." Once these rights are in place, we should be able to add several new US-made products to our line.

These rights will be critically important to those US companies that have yet to enter the Chinese market. At present, they can export their products to China but may have difficulty marketing and distributing them to customers. With full trading rights, restrictions on distribution will be lifted and companies that seek to enter the market can more effectively sell products that now just sit in warehouses.

Despite the problems, we believe that the Chinese government is making a good-faith effort to implement needed reforms. While I urge progress on the WTO commitments when speaking to Chinese officials, I also ask that US officials have patience with the Chinese as they struggle to create new policies in areas where they have little or no experience. We spoke earlier of the fragility of the banking sector; it is important to realize that, previously, China did not have a system of bank examiners. A colleague in the insurance industry recently relayed the challenges that China faces in that regard. He said that New York City has more insurance examiners than does China.

China needs help in developing the mechanisms to manage a market economy. It needs new banking and insurance laws and it needs to hire and train bank examiners and insurance regulators. Congress has authorized and appropriated funds to provide technical assistance to China as it strives to implement its WTO commitments. I urge Congress to continue doing so and to expand these programs, which are vitally important to modernizing the Chinese economy and, I would add, to improving the understanding in China of our country and the economic system that we enjoy. I would also submit that assisting the Chinese in developing an effective system to manage commercial banks will do more to advance the cause of permitting the RMB to float than will talk of tariffs and other retaliatory measures.

In this vein, let me add that our company has enjoyed great support from the Departments of State, Commerce and the US Trade Representative. I want to thank them for the support that their staffers have given us in our efforts to expand our business in China and our exports to China.

Like you, I have heard the horror stories of companies facing problems in China. However, I believe that most of these problems can be resolved if the companies get the help that they need from US government departments and agencies working in China. It follows that, if more US companies are to succeed in China, more support will be needed and more funds must be given to these agencies. I urge you to support full funding of these agencies so that US companies can succeed in China and elsewhere in the world.

US Policy Changes

I am proud of the fact that our company manufactures products in the United States and ships them around the world. I must confess that I am concerned about

[v] US Chamber of Commerce, *First Steps: A US Chamber Report on China's WTO Progress,* September 2002.

[vi] US-China Business Council, *China's WTO Implementation, An Assessment of China's Second Year of WTO Membership.* Testimony submitted to USTR, September 10, 2003.

the state of manufacturing in this country. Too many companies in our home State of Michigan have gone out of business or have had to downsize in recent years. We went through that very painful process a few years ago. I hope to never experience such a trauma again. In fact, I would like to find ways to bring those good people back to work in our company.

With this in mind, let me state that the US tax code, in our view, imposes a disproportionate burden on US manufacturers in overseas markets when compared to our foreign competitors. All of the products that our company exports carry the cost of government when sold because Alticor's corporate tax payments are built into the cost of the product. This remains true if the products are sold overseas.

In addition, the US tax system adds an extra burden to many American multinationals who establish regional distribution, service or treasury centers that are designed to efficiently service their foreign markets. Many of these companies must pay US tax on foreign-earned income that has not yet been repatriated to the United States.

In a rational trading system, each country should be able to adjust for tax policies at the border. Yet, according to the provisions of the General Agreement on Tariffs and Trade (GATT), adjustments can be made only on a product-specific basis, which is to say that a consumption tax such as the European style Value Added Tax (VAT) can be removed but a generalized tax such as a corporate income tax cannot.

As a direct consequence, the WTO has ruled that earlier efforts to adjust for this disparity violate trade subsidy rules. The EU has published a list of products on which duties will be levied if the Congress does not resolve this issue. Almost every product that Alticor exports to Europe is on that list. If Congress does not resolve this issue, we will likely find ourselves in serious trouble in the European market.

We applaud efforts in Congress to modernize the US tax code. I submit to you here today that doing so should be the highest priority of everyone who wants to save jobs in this country. The transcendent issue is American jobs. For decades, economists and others believed that the corporate tax system only burdened shareholders and capital generally. It is now clear that the corporate income tax (CIT) is contributing to the decline in manufacturing jobs in the United States.

In support of that statement, I would refer the Committee to two papers by Professor Arnold C. Harberger of the University of California at Los Angeles. The first, published in 1962, concludes that the corporate income tax was borne by "all owners of capital throughout the economy." [vii] That analysis focused on the economy as it existed when foreign trade levels were a fraction of what they are today. In June 1994, Harberger published a new analysis that examined the effect of the CIT in a world where trade flows have a significant impact on the US economy.[viii] He concluded:

> "[US] labor's wage must fall very sharply in order to absorb the tax wedge being inserted into the price structure of that part of the corporate tradables sector where final products are substantially homogeneous and whose prices are basically set in the world market. This wage fall is likely to mean that labor will bear 2 to 2½ times the full burden of the US CIT."

At Alticor, we are a part of the "corporate tradables sector where final products are substantially homogeneous." We take care to be as efficient as possible and to make products that can be differentiated in the marketplace. We must do so to protect the jobs—good, well-paying jobs—that we create here in the United States. We know that every Member of this Committee and, indeed, every Member of this Congress cares deeply about jobs here at home. We have all seen the figures: manufacturing jobs in the United States have been disappearing at the rate of 12 million per year.

I came here today to talk about China but my key message is that the problem is not with China or its policies. It is with our own policies.

The crisis in the US manufacturing sector is real and the time has come for all of us to address it. We believe that US manufacturers can become more competitive if we can find ways to reduce the costs that our tax system imposes on US businesses. We must find a way—consistent with the GATT rules—to reduce the burden that US tax policies place on manufacturing and on overseas operations that support US manufacturing. Only by doing that can we save jobs here in the United States.

[vii] Arnold C. Harberger. *The Incidence of the Corporate Income Tax,* Journal of Political Economy, June 1962.

[viii] Arnold C. Harberger. *The ABCs of Corporation Tax Incidence: Insights into the Open-Economy Case,* proceedings of a symposium sponsored by the American Council for Capital Formation, Center for Policy Research. Presented June 8, 1994. Published April 1995.

Thank you for your attention.

Mr. PORTMAN. Thank you, Mr. DeVos; and thank you for keeping your statement to under 5 minutes. That may be a record. I hope it will be a good model for the rest of our panel this morning. Mr. Malpass.

STATEMENT OF DAVID R. MALPASS, BEAR STEARNS, NEW YORK, NEW YORK

Mr. MALPASS. Thank you, Mr. Chairman and Members of the Committee. I am not sure I am going to be up to this task of 5 minutes, but I will endeavor. It is a very complicated issue—set of issues that you are dealing with, and I welcome the opportunity to address the Committee on it.

In my view, China's economic policies are solid enough to cause its economic and political role in the global economy to continue expanding.

I expect the United States to see a continued decline in the share of manufacturing jobs within our economy. That is being driven by productivity growth, by globalization, and by the 50-year secular process toward services, so this is not something new. It has been going on rather steadily for 50 years.

Dollar strength in the late 1990s accelerated the loss of manufacturing jobs. Remember, the dollar gained 30-percent strength in the late 1990s. That caused U.S. businesses to look outside the United States for goods and services to maintain their competitiveness. However, dollar weakness, now that the dollar has moved back to a normal level, would not, in my view, recover those jobs or stop future losses.

As it grows, China will get some of the blame for the U.S. job losses, just as Japan and Korea did in earlier decades. The United States also benefits, though, from China's economic success through lower input costs, new markets for U.S. products and cheaper consumer goods.

In my view, it would be harmful for China to float its currency or change its value substantially. This would cause deflationary instability in China's rural sector without stopping China's export growth. A Chinese reevaluation would be counterproductive for the United States in that it would actually accelerate the flow of capital technology and expertise to China. We have seen this repeatedly.

When Japan appreciated its currency in the 1980s, what happened? Capital and technology and expertise flowed heavily to Japan, and their competitiveness lead actually expanded, not contracting the way the strong yen advocates had suggested.

From China's policy standpoint, China should, in my view, develop and liberalize its capital and financial markets and broaden individual freedoms. China seems to agree with that and in some ways is moving in that direction. China I think should encourage growth in domestic consumption, and it should reduce import tariffs and add to the market orientation of its economy.

From the U.S. side, my view is that to have a healthy growth policy, the United States should encourage currency stability, less protectionism, lower tax rates, labor flexibility, and sweeping International Monetary Fund (IMF) reforms to encourage more growth in the developing world.

I should note we are in a formative part of the relationship with China, and it is important for the long run that the United States observe some of the changes going on in China.

Part of my testimony is about the growth and the drive for growth in China. China's growth rate is likely I think to taper in 2004. Our forecast is they will slow from an 8.5-percent growth rate down to a 7.8-percent growth rate.

I would like to note three of the key steps in China's economic development. We sometimes forget the massive changes going on in China.

First, it liberalized its agriculture system in 1978. That distinguished it from the Soviet Union, which is still today having massive problems with agriculture.

Second, in 1993, China's Vice Premier, Zhu Rongji, pegged the currency to the dollar. What this did was to stop inflation in China, and it brought low interest that set China apart from most other developing countries. One of the problems that Africa has and Latin America has is that their currencies aren't stable and so they do not invite investment to come into their countries in that way.

Then a third key factor in China's fast growth, one that we often forget, is that it has consistently rejected the IMF economic model of austerity and currency volatility, which has impoverished so many developing countries. China is doing a different model that is working better in terms of attracting investment and producing fast growth.

I would like to turn to page 10 in my statement which relates to jobs in the United States and in China. On a relative basis, the loss of manufacturing jobs in the United States has been a consistent trend for over 50 years, including job losses to Japan, Korea, and Taiwan. The United States, nonetheless, remained the leader in job growth in the developed world in those years, so we have to put our job losses in context of the United States being the fastest in job growth.

Like the United States, China has also been losing manufacturing jobs recently due to globalization and as the world has evolved. Since 1995, China has lost roughly 16 million manufacturing jobs. That is more than the total U.S. manufacturing jobs. As the Committee thinks about these issues it helps to put them in a globalization context in which almost the entire world is losing manufacturing jobs. The United States is part of that. The trend has been going on for 50 years. The most helpful policy developments both for the United States and China are to move more toward market orientation in their policies. Thank you, Mr. Chairman.

[The prepared statement of Mr. Malpass follows:]

Statement of David R. Malpass, Bear Stearns, New York, New York

Chairman Thomas, Mr. Rangel, members of the committee. Thank you for the invitation to testify on U.S.-China economic relations and China's role in the global economy. Throughout my testimony, I will be presenting my personal views, which are not necessarily those of my employer.

Summary

- In my view, China's economic policies are solid enough to cause its economic and political role in the global economy to continue expanding.
- I expect the U.S. to see a continued decline in the share of manufacturing jobs, driven by productivity growth, globalization and the 50-year secular process toward services.
- Dollar strength in the late 1990s accelerated the loss of manufacturing jobs by causing U.S. businesses to look outside the U.S. for goods and services. However, dollar weakness now would not recover those jobs or stop future losses.
- As it grows, China will get some of the blame for U.S. job losses just as Japan and Korea did in earlier decades. The U.S. also benefits from China's economic success through lower input costs, new markets for U.S. products, and cheaper consumer goods.
- In my view, it would be harmful for China to float its currency or change its value substantially. This would cause deflationary instability in China's rural sector without stopping China's export growth. A Chinese revaluation would be counter-productive for the U.S. in that it would actually accelerate the flow of capital, technology and expertise to China.
- From China's policy standpoint, China should develop and liberalize its capital and financial markets and broaden individual freedoms. China should encourage growth in domestic consumption by empowering private-sector job creation, reducing import tariffs, and adding to the market orientation of the economy.
- As part of healthy growth policy, the U.S. should encourage currency stability, less protectionism, lower tax rates, labor flexibility, and IMF reform to encourage more growth in the developing world.

China Growing Strongly

China's economy is growing fast, roughly 8% per year. It enjoys a stable currency, low interest rates, a U.S.-led global reflation, and an increasingly pro-market policy environment.

- China's growth rate is likely to taper moderately in 2004, following what is turning out to be a very robust post-SARS second half of 2003. Third-quarter real GDP growth registered 9.1% year-over-year.
- In 2004, net exports will slow and foreign direct investment should ease slightly, but we think domestic private consumption will continue rising. Thus, the composition of China's growth will shift but remain robust. We note that China's leaders remain prepared to use public spending as a support if needed.
- Our forecast is for 7.8% growth in 2004, following roughly 8.5% official growth in 2003. Actual growth is likely to be stronger than the reported figure, given that much of China's private sector economic activity is not fully captured by its statistical network.

I'd like to note three key steps in China's economic development.

- First, China liberalized its agricultural system beginning in 1978, a sharp contrast from the Soviet Union.
- Second, in 1993 under Vice Premier Zhu Rongji, China adopted a stable currency as a foundation for its economic growth. This stopped inflation and brought low interest rates, setting China apart from most other developing countries.
- A third key factor in China's fast growth is that it has consistently rejected the IMF economic model of austerity and currency volatility which has impoverished so many developing countries.

Putting China's Growth in Perspective

Though growing fast, China's economy started from a very lowbase. China's GDP will reach only about $1.35 trillion in 2003, up $100 billion from 2002. This compares to a U.S. GDP of $10.9 trillion in 2003, up $450 billion from 2002. Stated this way, the U.S. grew 4.5 times more than China in 2003 even though China has five times the population.

Similar comparisons would apply in other areas—China's investment growth is faster than U.S. investment growth, but dollar investments in the U.S. dwarf those in China; China's exports are growing faster, but the U.S. exports more (roughly $700 billion versus $400 billion for China.)

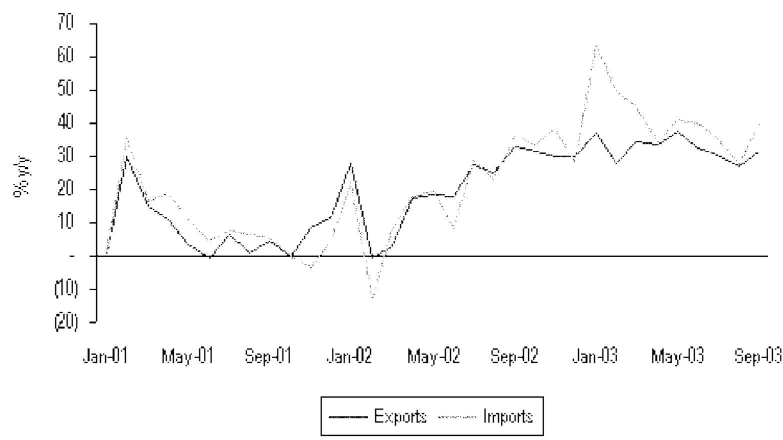
Still, China increasingly sees itself as Asia's leader. It is becoming increasingly dominant in the Asian economic and political outlook, especially given Japan's shrinking population and economic malaise. Meanwhile, its government remains communist, passing leadership from one generation to the next without benefit of democracy.

I think it is in the U.S. interest to see China continue to grow fast. History shows that countries become more democratic and more environmentally conscious as their per capita incomes rise. China has joined the World Trade Organization and seems to be playing a constructive role with North Korea.

China Trade

With strong growth in both consumption and investment, China's imports have been growing faster (+40%) than exports (32%). The secular trend will be for private consumption to play an increasing role in Chinese growth, relative to net exports, government spending or even investment.

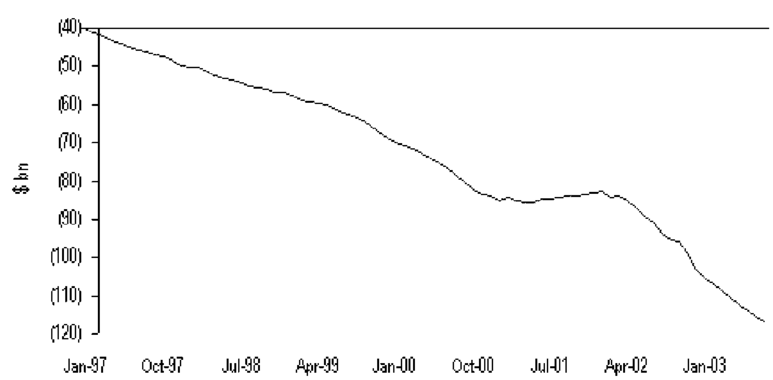
Chinese Export and Import Growth



Source: Bloomberg; Bear, Stearns & Co. Inc.

China has a large bilateral trade surplus with the U.S. Using U.S data, it was $117 billion in the twelve months through August. Using China's data (which treats trans-shipments through Hong Kong differently), China's bilateral trade surplus with the U.S. was $52 billion. Under both measures, new records were set in July and August.

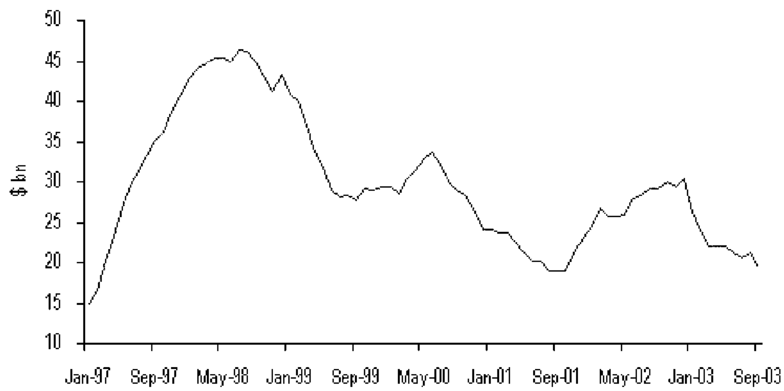
U.S. Trade Balance with China, 12-Month Moving Sum



Source: Bloomberg; Bear, Stearns & Co. Inc.

On a global basis, China's 12-month *overall* trade surplus has fallen to $20 billion from $45 billion in 1998. This puts the trade surplus at 1.6% of GDP, versus a U.S. trade deficit approaching 5% of GDP. Excluding China's surplus with the U.S. from its trade balance leaves China with a $32 billion trade deficit with the rest of the world.

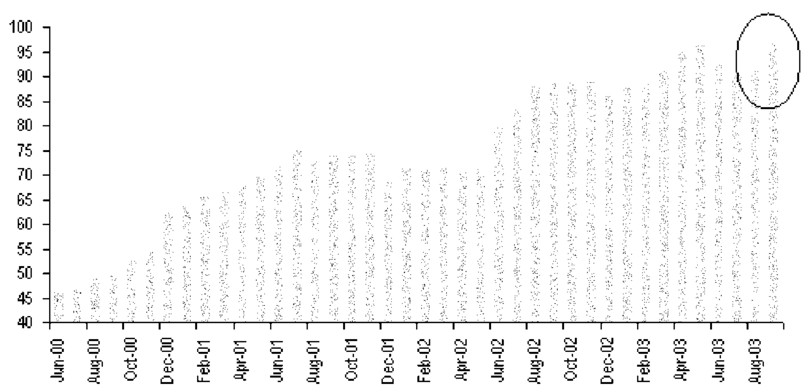
China's Trade Surplus, 12-Month Moving Sum



Source: Bloomberg; Bear, Stearns & Co. Inc.

- The 12-month rolling sum of China's pledged FDI reached a new all-time high at $96.6 billion in September, with the single-month sum alone at fully $11.7 billion. FDI thus appears set to remain a key source of growth and of private employment gains (supporting incomes and consumption) in 2004.

China: Pledged Foreign Direct Investment (12-month Rolling Sum, US$ billion)



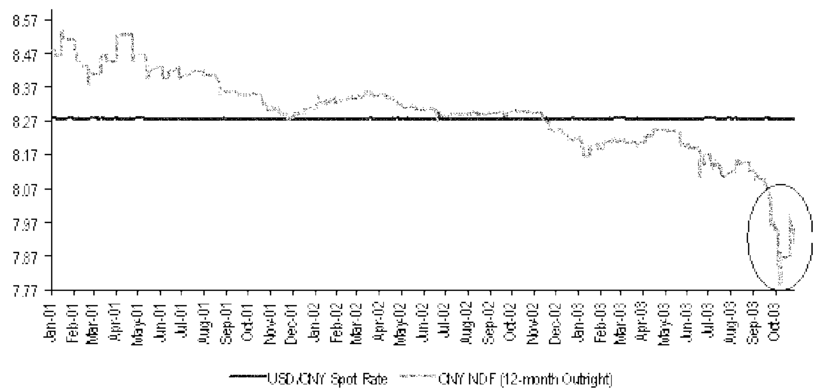
Source: Bloomberg; Bear, Stearns & Co. Inc.

With the US and G–7 placing increasing pressure for a change in the exchange rate regime, the markets are weighing the likelihood of a Chinese float. This process can be seen in the 12-month non-deliverable forward market for China's yuan currency.

- Yuan NDFs are effectively a play on the direction of the currency. Upon maturity, the contract is settled in U.S. dollars, not yuan. The contract does not cause any actual cross-currency capital flows and therefore doesn't have a direct effect on China's economy.

- The 12-month NDF is currently at 7.9092 yuan per U.S. dollar, as compared with the 8.28 yuan/$ spot exchange rate. This means that the market is effectively pricing a 4.4% appreciation of the Chinese currency on a 12-month time frame. This is known as a "premium" for the yuan.
- While NDF volumes are not large by international currency standards, the magnitude of the NDF premium means that sizable investments are being made on the possibility that China will be pressured into allowing the NDF yuan to strengthen.
- The NDF premium has receded somewhat since mid-October, when Treasury Secretary Snow suggested that the Chinese cannot "go there tomorrow" on a major exchange rate adjustment, and acknowledged that intermediate steps "like reducing capital controls" would likely have to be taken first.

Chinese Yuan: 12-month Nondeliverable Forward



Source: Bloomberg; Bear, Stearns & Co. Inc.

China's Monetary Policy

China's monetary policy is its fixed exchange rate rule at 8.27 yuan per dollar. Rather than setting interest rates or a money supply growth rate, it sets the dollar/yuan exchange rate. The tools to implement that rule include capital controls and currency intervention.

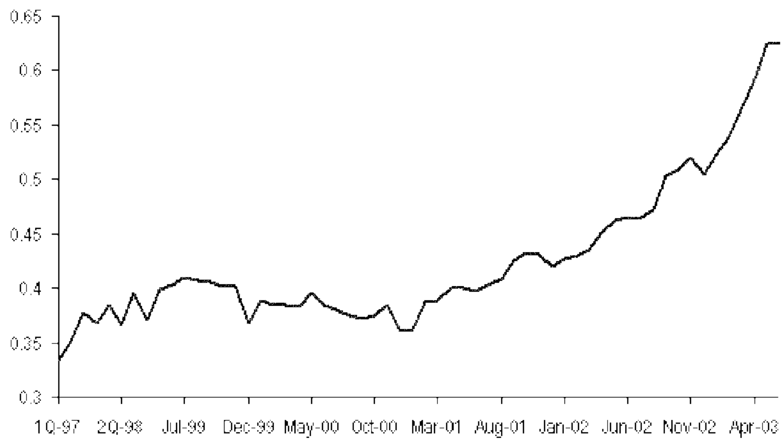
China has a balance of payments surplus, thanks not so much to its modest trade surplus but to its sizeable capital account surplus. FDI flows are one example of that sharp capital inflow, which has fueled a rise in international reserves in recent years.

The balance of payments surplus has increased the monetary base in China, which rose by 42% in the twelve months through June 2003. There is a difference between a currency board and a fixed exchange rate. In a currency board, the monetary base expands and contracts with foreign exchange reserves. The central bank usually does not hold many domestic assets on its balance sheet. All foreign flows in a currency board are unsterilized, meaning increases in international reserves are matched by increases in the monetary base.

The People's Bank of China (PBoC) has been only partially sterilizing its capital inflows. That means that, over that time, the share of foreign reserves backing the monetary base has risen from about 40% to 63%. If China were running a currency board, foreign exchange reserves would be roughly equal to the monetary base.

- Over the 12 months ending in June 2003, foreign exchange reserves on the PBoC's balance sheet rose by $103 billion, while the monetary base has increased by $33 billion. This might be phrased as 32% unsterilized, 68% sterilized.

Foreign Exchange Reserves (Percent of Monetary Base)



Source: Bloomberg; Bear, Stearns & Co. Inc.

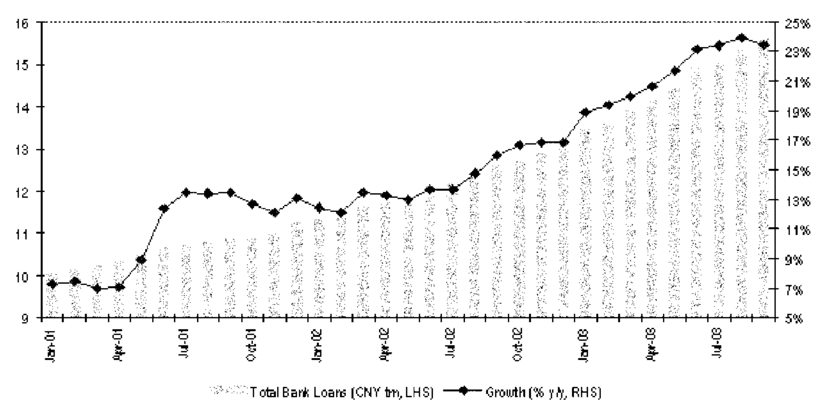
The combination of strong capital inflows and incomplete sterilization has left China's monetary base growing rapidly.

- Broad money, M2, rose 20.7% year-over-year in September, having risen 2.9 trillion yuan (US$345 billion) from December. By contrast, nominal GDP in the first three quarters was up "only" 10.4% vs. the same period in 2002.

The rapid buildup in bank lending continues to raise official concerns over financial system asset quality.

- September's 23.5% credit growth was only marginally slower than August's 23.9%. This doesn't show much impact thus far from the September People's Bank of China's (PBoC) one-percentage-point increase (to 7%) in the reserve requirement ratio for commercial banks.

China: Total Bank Lending

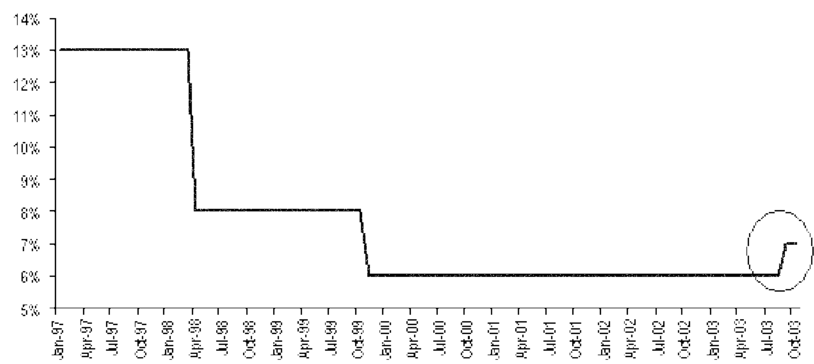


Source: CEIC; Bear, Stearns & Co. Inc.

- Chinese banks' credit modeling remains underdeveloped and banks still face regulatory and structural constraints on their ability to price risk.

- We think policymakers may place additional restraints on the expansion or availability of credit in coming months, likely through additional hikes in the reserve requirement ratios or through "administrative guidance."

China: Banks' Required Reserve Ratio



Source: CEIC; Bear, Stearns & Co. Inc.

Revaluation Would Be Harmful

Floating the yuan is a monetary policy decision that is fraught with risks to the financial sector and economy. China's commerce minister, Lu Fuyuan, told a group of European trade ministers in July that "China's major task at present is to maintain stable economic growth." We don't think this would be possible if the yuan were floating and therefore volatile.

- A material revaluation could restart China's deflation, undercutting consumption and ironically slowing China's booming import growth.
- A revaluation would complicate the task of state-sector downsizing and increase the already-high levels of bad debt in the state-owned banks.
- By depressing the yuan price of agricultural commodities, a stronger currency might slow China's rural economy and accelerate its already-rapid urbanization.

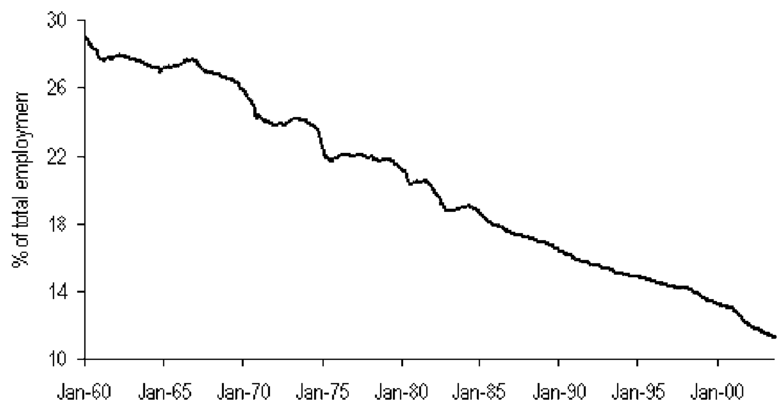
Even if a revaluation were "successful," it could cause China to build an investment bubble, just as Japan did in the 1980s under the strong-yen policy. Of even more concern, a Chinese revaluation trend would increase the pace of investment and job creation into China as it did to Japan in the late 1980s and the U.S. in the late 1990s. This would draw additional investment and capital away from other countries. China would use the faster capital inflow to upgrade the size and quality of its export base, again along the lines of Japan's experience in the 1980s, further enhancing its productive capacity and efficiency.

Jobs

I think China should be viewed as a competitiveness issue in the context of the long-term U.S. trend away from manufacturing. The theories of relative comparative advantage are some of the strongest in economics, arguing that flexible economies which allow resources to shift to higher value-added portions of the economy will benefit.

- On a relative basis, the loss of manufacturing jobs has been a consistent trend for over 50 years, including job losses to Japan, Korea and Taiwan.
- The U.S. nonetheless remained the leader in job growth in the developed world in those years.
- Like the U.S., China has also been losing manufacturing jobs recently as the world economy evolves.

Manufacturing Employment as Percentage of Total Employment

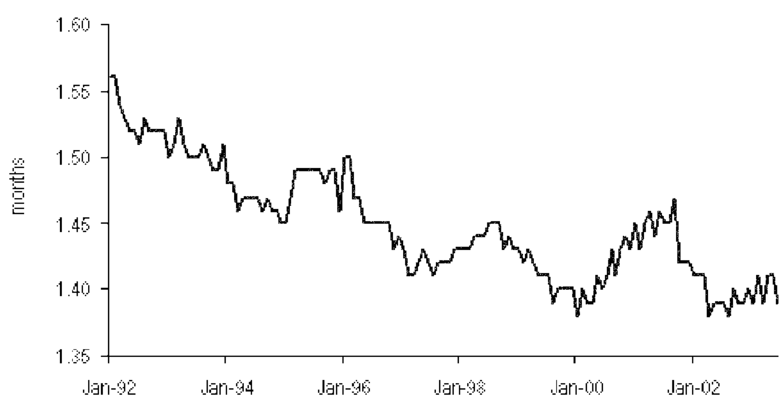


Source: Haver; Bear, Stearns & Co. Inc.

From a more near-term perspective, weak U.S. job growth has been consistent with other indicators of business caution—inventory depletion and relatively cautious business investment.

- Firms have been generally caught off guard by the strength of demand. The result was a sharp, we think undesired, decline in inventories in the second quarter, down $17.6 billion (in 1996 dollars). This subtracted 0.7 percentage point from overall Q2 growth.
- The ratio of inventories to sales has remained around its all-time low. As demand pressures on businesses grow, we expect that inventories will rise.

Ratio of Inventories to Sales

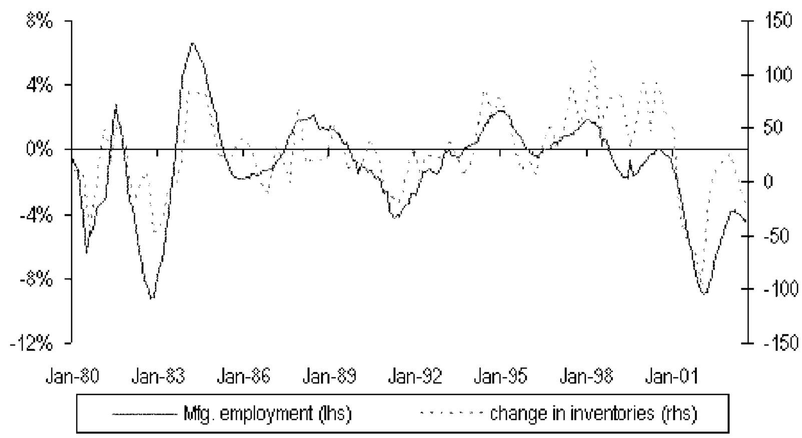


Source: Haver; Bear Stearns & Co., Inc.

- Inventory turnover increases when inventories are low. Similarly, productivity increases when job growth is slow. In effect, businesses worked their inventory and their employees hard in the second quarter because they underestimated their sales.

- This created strong profit growth in the second quarter and should lead to substantially faster U.S. production in the second half (to stop the inventory drawdown). Robust job growth should start in 2004.

Relationship Between Inventories and Employment



Source: Haver; Bear Stearns & Co., Inc.

Mr. PORTMAN. Thank you, Mr. Malpass. Mr. Jarrett.

STATEMENT OF JAMES W. JARRETT, PAST PRESIDENT, INTEL CHINA LTD., BEIJING, CHINA, AND VICE PRESIDENT, WORLDWIDE GOVERNMENT AFFAIRS, INTEL CORPORATION, SANTA CLARA, CALIFORNIA

Mr. JARRETT. Good morning. I am here on behalf of Intel. We are the world's largest semiconductor company, based in Santa Clara, California. We make chips for computers and cell phones and telecommunications equipment. Sales last year were almost $27 billion.

China has become a very important market for the semiconductor industry. Chips are our number two export to China, and it is their number one import from the United States, and it is now the second largest market in the world for personal computers. It is the largest market for cell phones. When I came to China in 1996, there were about 60,000 Internet subscribers at that point. Beginning this year, there were 60 million, so quite a change going on.

Our operations in China consist of sales and marketing, of course, but then also we are taking chips there. We have an assembly and test operation there, where we are taking chips that are manufactured in the United States and in Israel and in Europe and then we are putting them into packages and testing them before shipping them off to our customers. This is a function that has been offshore for about 30 years in the chip industry.

We also do software and research and development in China, because China has an abundant supply of well-trained electrical engineers.

China's record, in terms of the WTO so far, in our view, we would characterize it as a mixed record. They signed the information technology agreement, which is a good thing. They have eliminated tariffs on their information technology products. They signed the Trade-Related Investment Measures (TRIMs) accord and have taken away any contingencies on investment in China, which is a good thing. They signed the TRIMs accord and have changed their laws in very substantial ways to protect intellectual property. The enforcement of those laws is still kind of a patchy thing, so that is something to look at.

One thing that is a problem for us, there is a discriminatory VAT in China on semiconductors. If you bring a chip into China, you pay a 17-percent VAT. If you make it and design it in China, you pay a 3-percent VAT. In the opinion of the Semiconductor Industry Association, that is a violation of Article III of the General Agreement on Tariffs and Trade (GATT), so that is something we are working on.

In addition to being a big market, China is also working hard to become a competitor in chips. There is a lot of money to build chip factories in China right now, and so we need to look at how do we compete with China over the long term in this market. We think there are five answers to that question.

Number one, tax policy, and we know you are working very hard right now on a couple of things that are very important to us. That is the FSC successor, and the taxation on foreign income is very critical to us. I would like to see the research and development tax credit extended, and we hope you will look also at some additional incentives that will be needed over the long term to really keep America competitive as a manufacturing place in high technology.

Second, the Federal funding of research and development is something that is very important, particularly in the basic sciences, the basic research and physical sciences. This is an area that the Federal government has always been the lead player in, and in recent years the growth has really not been what it should have been, so we hope you will take a look at making a commitment to keep that commitment to research and development moving up.

Third, K through 12 education system is something that we are all going to need to look at in the United States, with particular emphasis on math and science. Our students simply aren't measuring up in math and science. We need a lot of well-trained people in math and science.

Fourth, we hope you will maintain a posture avoiding any protectionism. We really benefit from open markets, and we hope that we will continue to have that.

Finally, we really need to drive productivity. That is the real answer for us long term. We cannot compete on the basis of wages. We are going to have to compete on the basis of productivity. Thank you very much.

[The prepared statement of Mr. Jarrett follows:]

Statement of James W. Jarrett, Past President, Intel China Ltd., Beijing, China, and Vice President, Worldwide Government Affairs, Intel Corporation, Santa Clara, California

My name is James W. Jarrett and I am vice president of worldwide government affairs for Intel Corporation, Santa Clara, California. Prior to my current position, I was president of Intel China Ltd., based in Beijing.

Intel is the world's largest manufacturer of semiconductors, with sales in 2002 of $26 billion. We employ 79,000 people worldwide. About 60% of our employees are based in the United States.

Our products serve as the electronic brains of personal computers, servers, mobile phones, network equipment and many other products. Asia now accounts for half our sales, with Europe and The Americas representing roughly 25% each. The United States is our largest country market, followed by China, which recently surpassed Japan to become the second largest market for personal computers. China is also the largest market for mobile phones.

Due to the rapid rate of technological progress, Intel must invest heavily in new factories, and in research and development. During 2001–2002, the steepest downturn in the history of our industry, we invested $19.8 billion in these two categories. We continue to invest in the United States. Four of the world's newest and most advanced chip factories, for example, are Intel plants in the U.S. These factories together represent investments of approximately $8 billion.

Intel In China

As noted, China is a large and fast-growing market for Intel chips. It is both a major consumption market and an export location to other countries. In addition to selling to China, we are now performing a portion of our assembly and testing in that nation. We opened a chip assembly and test operation in Shanghai in 1998, and we recently announced plans to locate a second such facility in Chengdu, China. These facilities take chips fabricated at Intel factories located in the U.S., Ireland and Israel, and put them into packages and test them before final shipment to our customers worldwide. This assembly/test function has been almost entirely outside the United States for the past 30 years.

In addition, Intel is doing engineering work in China. We have a software lab in Shanghai and an R&D center in Beijing. These labs are part of a worldwide network of Intel Labs. China is attractive in part because it is now graduating substantially more electrical engineers than the U.S. Three other notes: 1) the number of electrical engineers graduating in the U.S. is declining, 2) about half the Ph.D. candidates in the sciences in U.S. universities are foreign born, and 3) once they graduate, we are sending more of those newly minted Ph.D.s back to their countries because the number of H1B visas available has now dropped substantially.

China's Compliance With WTO Requirements

China's compliance with WTO requirements has been mixed from the standpoint of the semiconductor industry. On the positive side, China has signed the Information Technology Agreement and eliminated tariffs on imported semiconductor devices. The nation is also a signatory to the TRIMS accord and seems to be meeting that treaty's requirements not to make approvals of foreign direct investment contingent upon export requirements, technology transfers and similar contingencies. In the area of intellectual property protection, China has signed on to the TRIPS accord and has been revising its laws accordingly. Concerns remain about enforcement of such laws, but it is clear China is working to improve.

On the negative side, China has a Value-Added Tax that treats imported and domestically made chips differently. An imported chip is taxed at 17%; a domestic chip is taxed at 3% after rebates. The Semiconductor Industry Association believes this is a violation of Article III of GATT, which prohibits discriminatory treatment based on a product's country of origin. SIA has raised this matter with the U.S. and Chinese governments and we are hopeful the problem can be resolved.

Competing In a Changed World

Intel is concerned about keeping America a strong and innovative competitor in the high technology markets of the future. We believe there are several public policy changes that can help make this happen. They are generally not short-term remedies because the problems we address are fundamental ones that do not lend themselves to quick fixes.

The first change we recommend is not a policy change itself, but rather a recognition by policy makers that America now competes in a changed world. Twenty years ago, China, India and Russia, with a total population of 2.5 billion people, were not participants in high tech; today they are eager and successful players. Thanks to the Internet, it is now possible to locate a research lab anywhere and manage it as if it were next door. Thanks to global free trade, it is now possible to take a microprocessor from the U.S., memory chips from Korea, a disk drive from Singapore and a monitor from Taiwan and turn them into a personal computer that can be assembled in China, Malaysia, and dozens of other countries. It is in short a different world and our policies need to reflect that.

Second, we recommend changes in U.S. tax laws to make the U.S. more competitive as a manufacturing location. We specifically recommend:

1. Make the R&D tax credit permanent and enhance it. Intel, like many high tech companies, spends heavily to develop new products and technologies. This year, for example, we will spend about $4 billion to keep our technology pipeline full of innovations that will provide the basis for the jobs of the future at our company. America's leadership in high tech is one of our great strengths, and the R&D tax credit is an effective way to help sustain it.
2. Make it feasible and cost effective for U.S. multinational companies to put to use in the U.S. earnings from offshore operations. Due to the structure of U.S. tax laws, there is an unfavorable economic penalty to bringing money back from overseas locations. Under current rules, even a loan of such funds for use in the U.S. will reduce those funds by 35%. We know the Committee is wrestling with this problem in the context of legislation to enact a WTO-compliant successor to the FSC/ETI provisions. In the short term, as a temporary solution to this problem, and as a strong growth catalyst for the U.S. economy, we urge passage of the Homeland Investment Act (HR 767 and S. 596) to prompt the move of an estimated $300 billion in cash from overseas operations into U.S. accounts.
3. Consider new tax measures to incentivize investment in new factories and equipment, job training and job creation. American corporations are visited daily by foreign governments offering rich packages of incentives. For example, countries are offering investment tax credits for capital investments, an incentive America ended in 1986.

Third, we recommend the Federal Government commit to increasing its funding of basic research and development in the physical sciences. The Government has traditionally been the primary source of funds for basic research conducted at the nation's universities, research institutes and national laboratories. These investments complement the work of corporations, which tend to concentrate on applied research and development. This tandem of public and private funding has produced a myriad of advances and a strong corps of highly trained people. In recent years, Federal funding for the life sciences has grown at a faster rate than the physical sciences. We believe it is important not to under-fund the physical sciences.

Fourth, we recommend increased emphasis on fixing our K–12 education system, with a special focus on improved math and science education. Our students simply don't measure up well in math and science versus students in other countries. The high tech workforce of the 21st century must be able to handle these disciplines well. For anyone interested in public policy measures to address math and science education problems in the U.S., I would refer you to the recommendations of the National Commission on Mathematics and Science Teaching for the 21st Century, headed by former Senator John Glenn.

Fifth, we must not back away from free trade. Past trade developments and liberalization in the information and communications technology industries have benefited consumers and the U.S. economy:

- Imports and exports currently equal over 50 percent of the value-added to ICT products. This figure is far higher than in the broader economy and has been rising for decades.
- These trade linkages have fostered the production and use of ICT products and strengthened U.S. ICT industries.
- Furthermore, the acceleration since 1995 in quality improvements and price declines in many ICT products coincides with three major WTO agreements of direct relevance to ICT producers: the 1995 TRIPS Agreement, the 1997 Information Technology Agreement and the 1997 Basic Telecommunications Agreement.

The positive role that trade liberalization has played in the development and growth of ICT products should be maintained and expanded.

America's competitive fitness will be tested in coming years as China and other emerging nations continue to develop. It is clear we can't compete with these nations on wages. Instead, we need to continue growing labor productivity. U.S. Government data show a sharp increase in U.S. labor productivity in the second half of the 1990's, due largely to the nation's heavy investments in ICT. Productivity growth can be a powerful tool in keeping the U.S. competitive.

In summary, we believe America can continue to be a leader in high technology if we start with a recognition we're in a more competitive world, reject a retreat into protectionist measures, and get on with doing the things that will keep us strong.

Thank you for the opportunity to appear before you today.

Mr. PORTMAN. Thank you, Mr. Jarrett. Mr. O'Hagan.

STATEMENT OF MALCOLM O'HAGAN, PRESIDENT, NATIONAL ELECTRICAL MANUFACTURERS ASSOCIATION, ROSSLYN, VIRGINIA

Mr. O'HAGAN. Good morning, Mr. Chairman, distinguished Members of the Committee. My name is Malcolm O'Hagan. I am President of NEMA.

We are the largest trade association representing the interests of electrical equipment manufacturers in the United States. Our sales exceed $120 billion. The 400 member companies of NEMA manufacture products used in the generation transmission distribution control and use of electricity. These products are used in the utility, industrial, commercial, institutional and residential markets. The association's Medical Products Division represents manufacturers of medical diagnostic imaging equipment, including magnetic resonance imaging (MRIs), CTs, x-rays, ultrasound, and nuclear products.

Mr. Chairman, China is the single biggest factor influencing our members' business these days. A few years ago, I asked members of our board if any of them had recently been to China, and I got blank stares. In the spring when I asked the question, just about every hand in the room went up.

Our board has approved a major China initiative for NEMA to help China deal with the new opportunities and challenges. As part of our China initiative, we will be opening an office in Beijing, with support from the Department of Commerce to a cooperative agreement in the form of a matching grant of almost $400,000. We are very grateful for this support from our government, and we look forward to working with U.S. officials, both here and in China, in advancing the interests of our industry under the very capable men and women who we employ.

Mr. Chairman, for our industry, China is a two-way street. It offers great opportunity, but it also raises substantial concerns and challenges.

Let me touch on the concerns first. We have major concerns relating to IPRs and counterfeiting. We have already encountered a number of counterfeit products as well as patent and trademark violations. We are concerned that Beijing's new product certification requirements would raise non-tariff barriers by adding costs or delaying market access.

We have concerns about subsidized products coming into this country, putting domestic producers at an unfair competitive advantage. With China's accession to the WTO, we are optimistic that these concerns will be addressed promptly and that China will fully comply with WTO rules, but we intend to closely monitor their actions.

China also represents great opportunities. There is enormous demand in China for the products that NEMA manufacturers make, from power generating equipment to medical technology. As Deputy Trade Representative Shiner noted in her remarks to the Committee yesterday, our member sales to China have gone up considerably in recent years. China is now our industry's number three export market. Moreover, we expect exports to continue increasing faster than any other foreign market. Fifty-eight percent of the respondents to a survey we conducted recently reported that they are selling product in China, and many have been doing so for years. Most expect the positive sales trend to continue.

Direct investment in China by NEMA members continues to grow, in order to serve the needs of both the domestic market in China and the export market.

In addition, China has become a valuable source of low-cost components and commodity products. Two-thirds of the respondents to our survey said they are already sourcing from China, and half of the rest said they soon planned to be.

Sourcing low-cost components from China allows our members to remain competitive. Having commodity products manufactured in China allows our companies to offer these products to consumers at attractive prices. According to our survey, the mean landed cost of product source from China is 27 percent less than what it would cost to manufacture here.

Finally, China poses a competitive threat to members of NEMA. Eighty-five percent of respondents to our survey said they are facing direct competition from Chinese manufacturers, and about 65 percent expect Chinese competition to increase significantly.

Our industry, like others, welcomes fair competition. Chinese companies must play by the rules of the game and comply fully with the results of the WTO. We will be competitive in certain areas and not in others. It is easy to point the finger at the Chinese when we are not competitive, but, in fact, many of the problems are of our own making. We can manufacture products better than anyone.

The productivity gains in the United States in recent years are phenomenal. Those making products is not the problem. The problem is the social costs that have been heaped upon manufacturers. The plaintiffs' bar has imposed enormous costs on manufacturers. Health insurance costs continue to drain more and more resources. Environmental, work safety, and our regulations add huge non-productive costs, and our tax code is punitive.

Thankfully, under the current Administration, industry has finally won some tax relief, but more is needed. We cannot blame the Chinese for what I have just detailed. We have to face up to the reality that we will not be competitive, and we will continue to lose good manufacturing jobs to countries where these costs are not mandated.

Now, Mr. Chairman, I thank you for conducting this hearing; and I thank you and your colleagues for giving NEMA the opportunity to offer these comments.

[The prepared statement of Mr. O'Hagan follows:]

Statement of Malcolm O'Hagan, President, National Electrical Manufacturers Association, Rosslyn, Virginia

NEMA, the National Electrical Manufacturers Association, is the largest trade association representing the interests of U.S. electrical industry manufacturers, whose worldwide annual sales of electrical products exceed $120 billion. Its mission is to improve the competitiveness of member companies by providing high quality services that impact positively on standards, government regulation and market economics. Our more than 400 member companies manufacture products used in the generation, transmission, distribution, control, and use of electricity. These products, by and large unregulated, are used in utility, industrial, commercial, institutional and residential installations. The Association's Medical Products Division represents manufacturers of medical diagnostic imaging equipment including MRI, CT, x-ray, ultrasound and nuclear products.

The Commerce Department has just chosen NEMA as one of the winners of its 2003 Market Development Cooperator Program competition, and we are honored to be entering into a cooperative agreement with the International Trade Administration in support of our China-related activities. This follows on the decision by our Board of Governors last spring to launch a new electrical industry initiative to assist our members with all aspects of their China-related activities—and of course our members continue to be very interested in opportunities stemming from Beijing's accession to the World Trade Organization (WTO).

To give you some background: Despite the high regard with which U.S. electrical products are often held abroad, our members often have trouble getting their products accepted into foreign markets on technical grounds and therefore feel that they need to play a greater role in helping other countries develop their electrical standards.

This is certainly the case with China. NEMA staff has long worked with the Administration and Capitol Hill on China-related trade issues—and some NEMA members have excelled there. Yet we are well aware that foreign companies have generally had trouble succeeding in China, and feel that our role as a trade association is to help U.S. electrical manufacturers avoid the pitfalls.

Nevertheless, U.S. electrical sales there have been growing rapidly in recent years to the point where the PRC and Hong Kong, when their figures are combined, has become our #3 "national" export market after Mexico and Canada. Little wonder that it is very much considered to be a market of even greater potential by our members—yet our exports could have grown much more were it not for a variety of tariff and non-tariff barriers.

To give you some examples:

Counterfeiting: Like numerous other sectors, the U.S. electrical industry continues to have fundamental, ongoing concerns about Intellectual Property protections in the People's Republic. Our members continue to be victimized by repeated, vast trademark infringement abuse. China has to keep on strengthening its anti-counterfeiting measures and enforcement.

Potentially "Subsidized" Product Coming Into the U.S.: We have received reports from some of our members complaining about unfair competition from extremely low-priced Chinese electrical imports. Since the goods in question are frequently not labor-intensively produced, these member companies are concerned that the Chinese government may be subsidizing the purchase of raw materials and/or providing them below cost via state-owned enterprises. China has made WTO accession commitments regarding state-trading enterprises and subsidies; we trust the USG will join us in encouraging China to meet and keep those commitments, which include eliminating specific export subsidies and providing full information on the pricing mechanisms of its state trading enterprises for exported goods.

The CCC Mark: The new China Compulsory Certification (CCC) mark is also of particular concern to our industry. The costs of compliance are exorbitant. Moreover, while Beijing committed upon entering the WTO to change its conformity assessment procedures so as to afford non-Chinese product "national treatment", for many electrical products with the CCC it has also moved to accept only goods built to either Chinese national standards or standards developed and published by the International Electrotechnical Commission (IEC) and International Standards Organization (ISO). (The latter still frequently does not include products built to U.S. requirements.) Since the end to the "grace period" for implementing the CCC only just ended on August 1, it still too early to judge how implementation is proceeding in practice—but the non-acknowledgement of North American-based international standards still remains.

The introduction of the CCC was declared on December 7, 2001—just prior to China's WTO accession. As a result, WTO member governments did not have a chance to comment as per the WTO Treaty on Technical Barriers to Trade (TBT). While the streamlining of China's conformity assessment is welcome—especially if it really does lead to "national" treatment for U.S. electrical goods—it is clear that, unfortunately, that the Chinese have developed their technical requirements with precious little input from U.S. sources.

As it happens, much still needs to be done on the CCC, since the Chinese have left a number of details outstanding or unavailable in English with regards to implementation, such as precise classification of which products are affected, exclusions, education of customs officials, what exactly is needed when applying for the mark, etc.

Under these circumstances, the U.S. Government and NEMA need to be reaching out to Chinese authorities to expand the range of acceptable electrical norms, as well as better inform them about their standards and conformity assessment options in general. Under the auspices of our MDCP with the Commerce Department, we intend to begin working with the Chinese in this direction.

Thank you for your consideration of these remarks.

Mr. PORTMAN. Thank you, Mr. O'Hagan. I would like to turn to my colleague from Missouri, Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman. I am privileged to introduce a fellow Missourian today who is presenting testimony on behalf of the American Farm Bureau Federation.

As you know, Mr. Chairman, agriculture is one of the few U.S. sectors that enjoys a positive trade balance. I have known Charlie Kruse for many years. He has been a long-time family friend. He has been President of Missouri's Farm Bureau for 11 years. He is known as a leader in agriculture not just in our home State of Missouri but across the country; and while I intended, Mr. Chairman, to ask him his opinion about the energy conference and ethanol bio-diesel, it is not the subject of today's hearing.

He is, though, well-versed to speak on the subject matter today. Charlie has led several trade trips abroad, including China. Not only does he speak with authority, but he is, as I am, a family farmer, an active farmer. He is a fourth generation farmer, along with his wife Pam. He is not a constituent. He is actually Representative Jo Ann Emerson's constituent, but he is a friend, and I am privileged to introduce you and look forward to your testimony.

STATEMENT OF CHARLES E. KRUSE, PRESIDENT, MISSOURI FARM BUREAU FEDERATION, JEFFERSON CITY, MISSOURI, AND MEMBER, BOARD OF DIRECTORS, AMERICAN FARM BUREAU FEDERATION

Mr. KRUSE. Thank you very much, Congressman Hulshof. I am proud to call you my friend, and we have been friends a long time. Congressman Hulshof's father, Paul, was a good friend of mine. I know you miss him every day, and so do we.

Mr. Chairman, thank you very much for the opportunity to speak to Members of the Committee on Ways and Means this morning. I am Charles Kruse. I am President of the Missouri Farm Bureau and serve on the Board of Directors of the American Farm Bureau. As Congressman Hulshof said, I am a fourth generation farmer, and that is where my passion lies. I appreciate this opportunity, and I commend this Committee for holding this hearing.

The Farm Bureau has trade and economic concerns with China. Nevertheless, over the past couple of years, we found China overall to be a positive trading partner. This is very important because agriculture in the United States is increasingly dependent on foreign trade. We look to developing nation markets as the best targets for future trade growth; and we look particularly to growing markets in the Asia Pacific region, especially to China, as the area where both income and population growth will offer the greatest opportunities for future trade successes.

As Congressman Hulshof stated, agriculture is in a unique position, enjoying over a billion dollars trade surplus with China. Since 1998, we registered strong gains in exports of soybeans, hides and skins, consumer-oriented products such as red meat, poultry meat, dairy products and fresh and processed fruit and vegetables.

Total exports to China grew by more than 54 percent during this period. Conversely, imports of agricultural products from China since 1998 have grown but at a slower rate of 34 percent.

To U.S. agriculture, China is a great opportunity, while, as other people testifying this morning have said, at the same time it is a substantial threat. In many respects, it is a developing country, yet it has become a dominant producer and a world-class exporter of many agricultural products.

Combining the value of U.S. exports directly to China and its special administrative region, Hong Kong, with the value of U.S. exports already sold to other countries, Japan, Korea, Taiwan, and the Association of Southeast Asian Nations, where China is pursuing bilateral trade agreements, it is easy to see that China has the ability to strongly affect more than $16 billion annually of U.S. agriculture exports. That is more than 29 percent of our total exports and roughly equivalent to the total exports with our North American Free Trade Agreement (NAFTA) trading partners, Canada and Mexico, so I think we can see very quickly that China has a lot of issues for all of us. Certainly agriculture is no exception.

With regard to monetary policy, certainly more explicit testimony has already been provided to the Committee that I will not duplicate. We strongly support efforts that urge China to reform its monetary policy in a manner that results in a gradual but deliberate adjustment to market-driven principles.

Although U.S. agricultural exports to China have increased since 1998, China still maintains barriers to imports of many U.S. agriculture products. The most obvious of these barriers is the manner in which China has implemented its system of TRQs. It almost seems that China imposes some trade restrictions based on their need for certain products. When they have a strong need in their country, they do not raise as many red flags, so to speak, as perhaps when their domestic supplies are available to their people.

Again, our view is that the United States should not hesitate, as a last resort and as a necessary resort, with its monetary policy or TRQs or whatever, to impose and use trade remedy tools if that becomes necessary.

Another issue I want to quickly mention is the whole issue of SPS violations. This is an issue where countries of the European Union become masters of raising SPS concerns, and China has done so with soybeans in the terms of genetically enhanced crops that we try to sell there, as well as an issue, Congressman Hulshof, that we are very familiar with in the area of Missouri where we farm, Phytopthera Root Rot, they raised that as a concern. We think that is pretty invalid, but nevertheless, they did.

I would just—in summary, Mr. Chairman, Members of the Committee, I would applaud you for holding this hearing. I think it is vitally important that we continue to keep before the American people as well as the Chinese the importance of fair and free and open trade with China.

In 1994, China had roughly 100 million people that were considered middle class, that had the wherewithal to make purchases that they chose. By 1996, that number had reached 350 million people; and by the year 2006 it is projected that that number will be over half a billion people. I think that right there demonstrates the potential we have in trade with China.

I thank you for this opportunity, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Kruse follows:]

Statement of Charles E. Kruse, President, Missouri Farm Bureau Federation, Jefferson City, Missouri, and Member, Board of Directors, American Farm Bureau Federation

Thank you Mr. Chairman, members of the Committee, I am Charles E. Kruse, President of the Missouri Farm Bureau Federation, a member of the Board of Directors of the American Farm Bureau Federation, and a corn, wheat, soybean and cotton producer from Dexter, Missouri. It's my pleasure to appear before you today to give the views of the AFBF on U.S.-China economic issues, which focus mainly on trade in agricultural products.

AFBF has trade and economic concerns with China. Nevertheless, in the past couple of years AFBF has found the Chinese overall to be constructive trade partners. This is important because, as the charts in the appendix to this statement demonstrate, U.S. agriculture:

- is increasingly dependent on foreign trade,
- looks to developing nation markets as the best targets for future trade growth,
- and looks particularly to growing markets in the Asia-Pacific region, especially to China, as the area where both income and population growth will offer the greatest opportunities for future trade success.

The U.S. enjoys an agricultural trade surplus with China of more than $1 billion.[1] Since 1998, the U.S. has registered strong gains in exports of soybeans, hides & skins, and consumer-oriented products such as red meat, poultry meat, dairy products, and fresh and processed fruits & vegetables. Total U.S. agricultural exports to China grew by more than 54 percent during this period.

Conversely, imports of agricultural products from China since 1998 have grown, but at a slower rate of 34 percent. China made significant gains into the U.S. market for intermediate and consumer-oriented products such as fresh and processed fruits and vegetables including juices, nursery products, and miscellaneous high-value products.

To U.S. agriculture, China is a great opportunity while at the same time it's a substantial threat. In many respects it is a developing country, yet, it has become a dominant producer and a world-class exporter of many agricultural products, including corn, vegetables, fruits & nuts, soybean meal, pork, sugar and confections, food ingredients, and rice. Moreover, it has established or is in the process of establishing preferential or free trade agreements with several current and very important customers of U.S. agricultural products in the Asia-Pacific region, including Japan, Korea, Taiwan, and the ASEAN countries.

Combining the value of U.S. exports directly to China and its Special Administrative Region, Hong Kong, with the value of U.S. agricultural exports already sold to these preferred trade partner countries, it's easy to see that China has the ability to strongly affect more than $16 billion of annual U.S agricultural exports;[2] more

[1] U.S. Bureau of Census Trade Data/USDA–FAS BICO, CY2002.

[2] Sum of the value of total U.S. agricultural exports to Japan, Korea, Taiwan and ASEAN–10 divided by the total value of U.S. agricultural exports to all countries in 2002; USDA/FAS BICO.

than 29 percent of the U.S. total. This is an amount roughly equivalent to the total annual value of U.S. agricultural exports to our NAFTA partners, Canada and Mexico, and does not take into consideration the effect of China's imports on domestic U.S. markets and production. Without question, China is a market with which the U.S. must be strenuously engaged on economic and trade issues for many years to come.

SPECIFIC ISSUES THAT NEED VERY CLOSE ATTENTION

China has made considerable progress towards trade liberalization, which is in stark contrast to that of a similarly large population, developing country that has been a member of the WTO for a far longer time, India. However China still has a considerable distance to go to be in full WTO compliance, which is why these annual reviews are so important.

Monetary Policy

China's monetary policy has a significant and, at the moment, negative impact on U.S. agriculture by increasing the landed price of U.S. exports while decreasing landed prices of Chinese imports relative to what would be expected from market signals. Much has been made of this issue by other business organizations and economists, and more explicit testimony has already been provided to the Committee that I won't duplicate. AFBF strongly supports efforts that urge China to reform its monetary policy in a manner that results in a gradual but deliberate adjustment to market-driven principles. AFBF hopes this can be accomplished through negotiation however, failing that, AFBF supports imposition of import duties on Chinese products if it is determined that China's system of monetary management is non-compliant with its obligations as a member of the WTO.

Market Access Barriers

Although U.S. agricultural exports to China have increased since 1998, China still maintains significant barriers to further imports of many U.S. agricultural products. AFBF has noted the irony with which many of China's import barriers are used seemingly for the purpose of limiting access to its market at times when domestic supplies are plentiful and import adjustments are needed to protect the value of domestic production.

The most obvious of these barriers is the manner in which China has implemented its system of **tariff rate quotas (TRQs).** Implementation of the TRQs has been only semi-transparent, has restricted the manner in which products imported under quota may be marketed in China, has required some in-quota imports to be re-exported to third countries, and has made importing U.S. products difficult for Chinese buyers by allocating quotas in such small quantities that purchases could not be made in commercially viable amounts. The Chinese were also months late in announcing the TRQs.

Notwithstanding the efforts of the President and the Office of the U.S. Trade Representative to negotiate reform in TRQ administration, progress has been slow. The Chinese have proposed changes that would address a few U.S. concerns including a plan to drop allocating quotas between "general traders" and the "processing trade". But many of the problems continue to exist. Should reasonable negotiation to bring further reform fail, the U.S. has clear grounds upon which to file a WTO complaint and prevail in a formal dispute settlement proceeding. The U.S. should not hesitate to use this trade remedy tool if necessary to preserve or enhance U.S. trading rights.

Another less transparent but equally effective barrier to further market access is the use of **sanitary and phytosanitary (SPS) "violations"** to block the unloading of cargoes that are alleged to have failed China's SPS import protocols. The most recent example is China's sudden imposition of vague rules regarding the import of genetically modified soybeans. Citing unknown health and environmental hazards, China pronounced with little advance notice that it would not accept genetically modified soybeans unless or until each genetically modified soybean "event" had been approved by the Chinese government, and then only after considerable testing and evaluation.

Through the efforts of the President, the Office of the U.S. Trade Representative, the USDA, the Dept. of State, the Congress and the U.S. agricultural industry, China agreed to an interim protocol that eventually allowed imports of soybeans from the U.S. to continue while it completes construction of its permanent approval system in early 2004.

SPS was the basis this summer of another claim by the China quarantine agency, which made a list containing several U.S. soybean exporters who had allegedly violated China's phytosanitary import standards. The agency threatened to halt soybean imports from companies on the list. Again, the Office of the U.S. Trade Representative, the USDA, the Congress and U.S. agriculture commenced bi-lateral negotiations with the Chinese to resolve issues and keep trade flowing. Efforts continue at a technical level to resolve outstanding issues, but the situation illustrates China's inconsistent and arbitrary enforcement of its own import regulations. The regulations upon which this dispute is based had not previously been enforced and, in fact, had been deliberately overlooked by Chinese officials for a considerable period of time.

And finally Mr. Chairman, it's very important that **U.S. trade remedy tools be more effective** in addressing disruption to the U.S. market caused by significant increases in imports of lower-priced agricultural products from China. AFBF recognizes that trade remedy tools such as countervailing duties and antidumping measures are intended to allow domestic producers the opportunity to adjust to import competition. But their application to China, as a Non Market Economy, has failed to bring needed and justified relief to certain import sensitive agricultural sectors.

For example, the U.S. apple industry has been severely affected by rapid increases in imports of apple juice concentrate (AJC). From 1995 to 1998, imports of AJC from China increased an astounding 2000 percent as the imported price of AJC from China decreased 53 percent from $7.65/gallon to $3.57/gallon. Consequently, China's share of the U.S. market increased rapidly from one percent in 1995 to 18 percent in 1998. While I am not totally familiar with the apple market myself Mr. Chairman, I am told that juice apples set the floor for the entire apple industry. Thus actions by the Chinese dropped the price of all apples in the United States.

Using U.S. trade laws in response, the U.S. apple industry went to the Department of Commerce and the International Trade Commission. Both found the apple juice industry had suffered economic damage and levied antidumping duties.

However, the Chinese appealed these duties. On a remand from the Court of International Trade, the Department of Commerce changed their methodology, ultimately reducing the level of the antidumping duty to the point that Chinese apple juice is once more entering the U.S. marketplace, building market share and causing economic damage to the U.S. apple industry. Understandably, U.S. apple producers have lost faith in the process.

It is absolutely essential, Mr. Chairman, that agencies which administer trade remedy and compliance laws in the U.S. must be vigorous in their defense of U.S. industries and businesses against unfair trading practices. This is especially true when administering trade remedy laws in defense of unfair trading practices undertaken by Non-Market Economy countries such as China.

Thank you for the opportunity to present our views on this vitally important topic. I look forward to answering any questions that you and members of the Committee may have.

APPENDIX I:

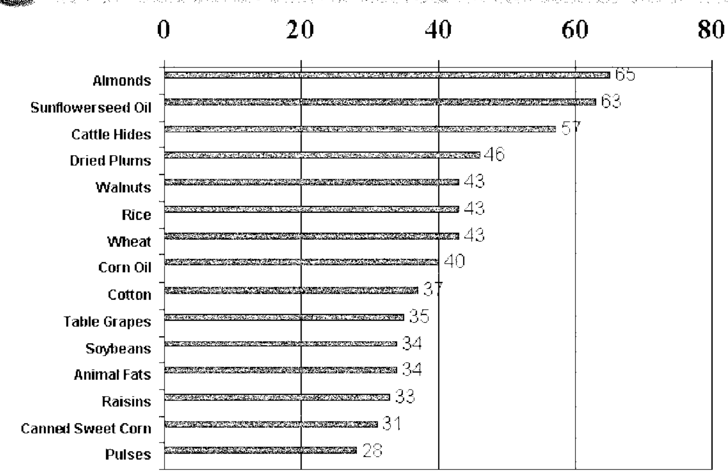
The Importance of Trade With China and Asia to the Economic Vitality of U.S. Agriculture

Importance of Trade

- The future of American agriculture is dependent upon maintaining existing export markets and creating new opportunities
- The greatest potential for future expansion of agricultural exports lies with the burgeoning middle class in developing countries

1

Many Products Depend on Overseas Markets

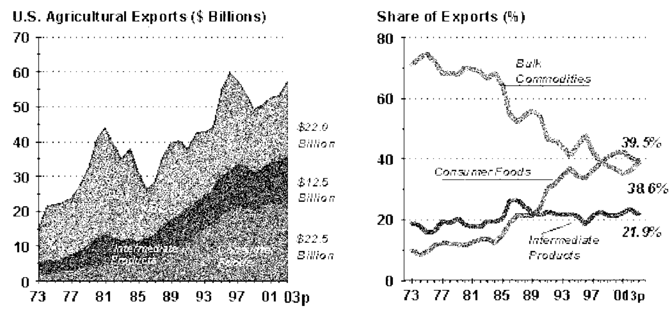


Percent of Domestic Production Exported
(1998 – 2000 Average Volume)

2

Rising to $57 Billion, Export Recovery Continues Into 2003

Consumer food exports SURPASSED bulk commodities in 1999; long-term shift expected to continue

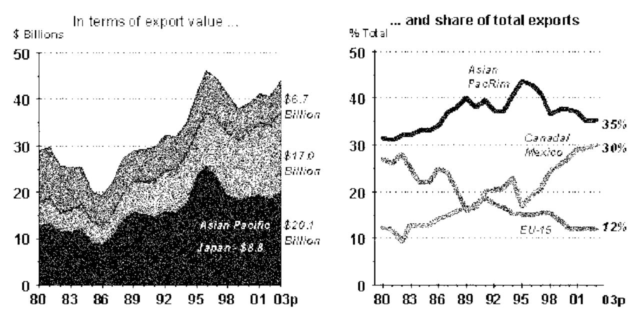


Source: FAS *BICO* Report (US Bureau of Census)

3

Asian PacRim Nations & NAFTA Partners Have Become Increasingly Important

The EU's importance continues to slip.



Note: Canadian import data are used as a proxy for US exports to Canada prior to 1990. Source: US Bureau of Census

4

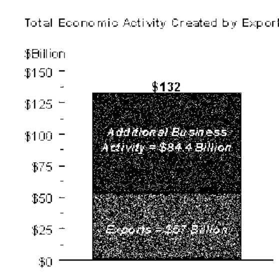
Top Markets' Export Performance Over 10 Years (Exports in US $Billions)

	1992	2002	% Δ
▪ Canada	$4.9	$8.7	75
▪ Japan	$8.5	$8.4	-2
▪ Mexico	$3.8	$7.3	91
▪ EU	$7.5	$6.1	-18
▪ Korea	$2.2	$2.7	23
▪ China	$0.5	$2.0	300
▪ Taiwan	$1.9	$2.0	1
▪ Hong Kong	$0.9	$1.1	22
▪ Egypt	$0.8	$0.9	14

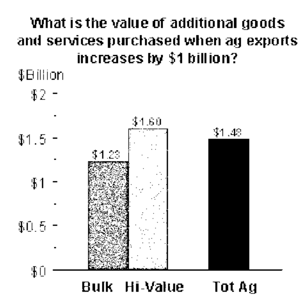
5

In 2003, US Agricultural Exports Expected to Generate $84.4 Billion in Supporting Activities

U.S. agricultural exports support additional services to harvest, process, package, store, transport and market product. High-value products generate more additional economic activity than bulk goods...



Source: USDA/ERS (2000)



6

The Global Market Landscape

- *Developed country markets:* mature, slow growth

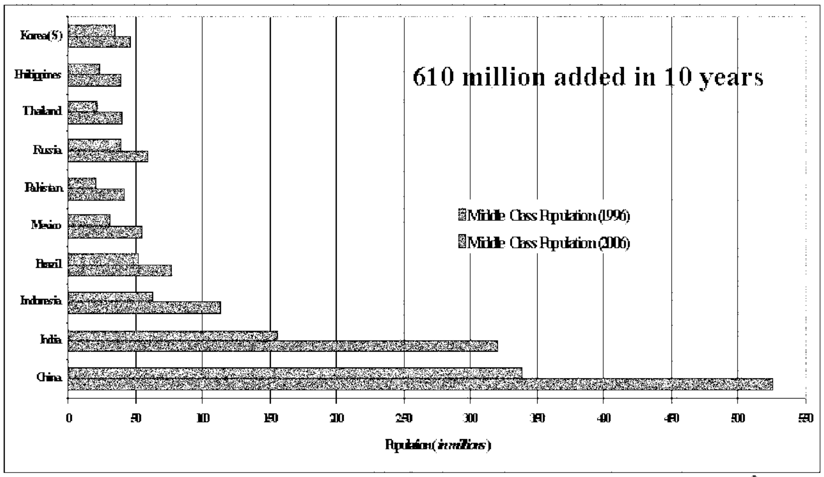
- *Developing country markets:* more rapid growth (population and incomes), more potential but more uncertainty

The Global Market Landscape

- Solid long-term fundamentals for growth in developing country demand for food
  - Rising incomes mean expanding demand for:
    - More/better food
    - Greater variety in diets
    - More processed (value-added) foods
    - More livestock products (requiring feed grains and proteins)

Future Markets: A Growing Middle Class

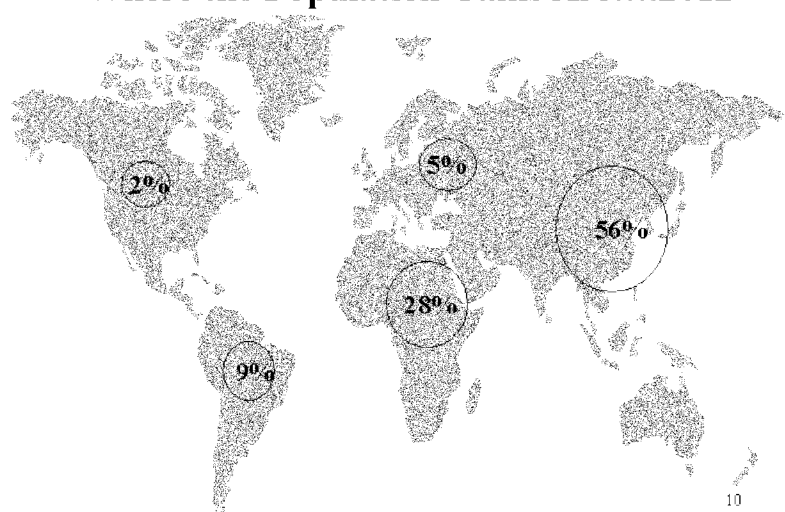
10 Largest Growing Middle Class Populations by Developing Country



9

Global Market Landscape

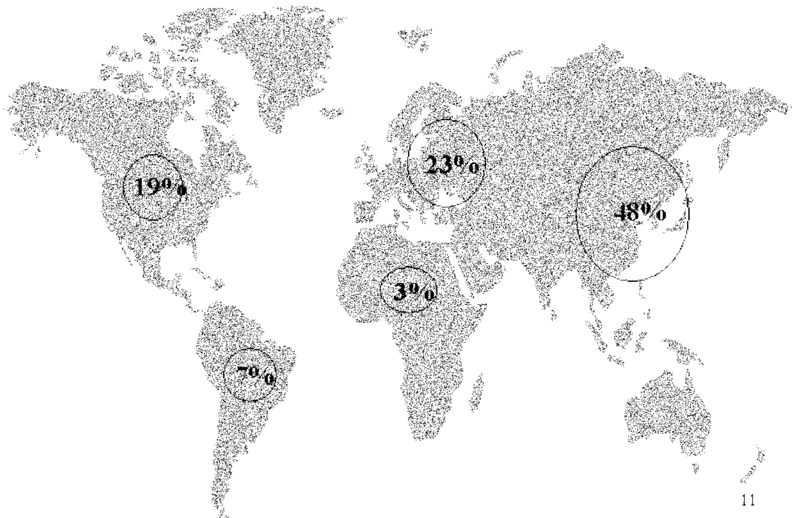
Where the Population Gains Are....2012



10

Global Market Landscape

Where the Economic Growth Will Be…2012



11

Global Market Landscape

- Conclusion: the future economic viability of American agriculture will depend upon our ability to develop and create market opportunities in the growing middle class in developing countries

12

Mr. PORTMAN. Thank you, Mr. Kruse. Mr. Papovich.

STATEMENT OF JOSEPH PAPOVICH, SENIOR VICE PRESIDENT INTERNATIONAL, RECORDING INDUSTRY ASSOCIATION OF AMERICA

Mr. PAPOVICH. Thank you, Mr. Chairman and Members of the Committee. On behalf of the Recording Industry Association of America, I appreciate the opportunity to testify today, and I have submitted my full testimony for the record.

Foreign sales account for over 50 percent of the revenues of the U.S. record industry, so we are very dependent on access to other markets and to being able to limit the piracy of our products in other countries. We share our problems in China with other U.S.-copyright-based industries which, together with us, account for over 5 percent of the U.S. GDP. Our industries have been involved in IPR negotiations between the United States and China since 1992. The special section 301 negotiations in 1995 and 1996 resulted in agreements obligating China to close factories producing and exporting pirate optical discs all over the world.

Today, despite China's various commitments and efforts, we face four related problems.

First, Chinese factories in the past, as I said, produced and exported huge quantities of pirated compact discs (CDs). This was stopped by the 1996 agreement. It is resuming, and we are now finding pirated Chinese CDs entering our major markets all over the world.

Second, the Chinese market remains almost entirely pirate, despite thousands of raids and tens of millions of CDs seized annually by the Chinese, in part because the penalties that they impose are just too small. Pirated music sales continue to exceed half a billion dollars a year in China, and the market is over 90 percent pirated product.

Third, Internet and broadcast piracy are rapidly growing in China.

Fourth, market access and investment barriers of the Chinese prevent our members from serving China in a timely manner, which perversely increases the demand in China for pirated product.

China must but has not taken steps to effectively address these problems. We were recommending the following:

First, a high-visibility nationwide campaign in China against piracy, led by a vice premier that Chinese enforcers take seriously. A problem has consistently been that the enforcers do not take these efforts seriously.

Second, China's administrative finds upon which they now rely are too low to deter anyone. They should be raised significantly.

Third, and more importantly, China must criminally prosecute pirate traders, producers, and distributors. Today China does not, in part because their criminal law discourages prosecutions. For example, their law permits criminal investigations only if the pirate that has been caught has documented revenues or profits that exceed specified levels.

Revenue is defined as goods already sold. A warehouse full of unsold pirated goods is not counted. Pirates, of course, keep no records, so that revenue or profits cannot be determined. Their law has to be made more realistic, and we are pushing hard for this.

In addition, Chinese customs, when they do seize pirated product, refuses to refer seizures, no matter how large, for criminal prosecutions. This relates directly to the surge in pirated Chinese exports that we are experiencing. Criminal prosecutions have and should occur against large Customs seizures.

The WTO TRIPS agreement requires China to provide deterrent penalties against piracy. To date, China has not done so.

Finally, to combat piracy, China must also liberalize its market access and investment barriers. China's regulatory procedures make it difficult for our companies to establish and operate. My full testimony describes this in detail. I will provide two examples.

First, Chinese government censors are required to approve the content of foreign-produced recordings before release but not domestically made Chinese recordings. China should terminate this discriminatory practice and at least accelerate its censorship process. This process is now very time consuming, during which time pirates face no censorship, have the market to themselves.

Finally, China requires a complex, non-transparent and artificial division of labor separating who can record music, publish music, and retail music that slows to a crawl the process of getting a new record to the market, further benefiting the near monopoly that the pirates enjoy.

So, as you can see, we believe, much more needs to be done for China to meet its obligations in this area; and I must say we applaud the fact that Secretary Evans and Ambassador Zoellick, who have been in China recently, have been working hard on this. There was a nice picture in this week's New York Times of Secretary Evans holding a pirated CD that he found in China. We are glad that they continue to press these issues for us.

The Chinese government must acknowledge the nexus between market access and fighting piracy. The vacuum caused by China's market barriers will always be filled by pirates who, by the nature of their illegal activities, did not adhere to legitimate market rules.

We urge the United States to increase pressure on China bilaterally and as appropriate in the WTO to more effectively combat copyright piracy and to open the markets to our legitimate products. Thank you very much.

[The prepared statement of Mr. Papovich follows:]

Statement of Joseph Papovich, Senior Vice President International, Recording Industry Association of America

Mr. Chairman and Members of the Sub-Committee, on behalf of the Recording Industry Association of America, I appreciate the opportunity to testify about U.S.-China economic relations and China's role in the global economy. The Recording Industry Association of America (RIAA) is the trade group that represents the U.S. recording industry. Its mission is to foster a business and legal climate that supports and promotes our members' creative and financial vitality. Its members are the record companies that comprise the most vibrant national music industry in the world. RIAA members create, manufacture and/or distribute approximately 90% of all legitimate sound recordings produced and sold in the United States. We work closely with other copyright-based associations such as the Motion Picture Association and the Entertainment Software Association and to a certain extent this testimony reflects their concerns as well.

International markets are vital to our companies and our creative talent. Exports and other foreign sales account for over forty fifty percent of the revenues of the US record industry. This percentage is even higher similar to those in related industries suffering similar problems like such as the motion picture industry. This strong export base sustains American jobs.

However, America's creative industries are under attack. The impact of piracy has grown in recent years with the advance of digital technology. High levels of piracy, in conjunction with market access barriers in certain countries—most notably China, plague our industries.

Our Problems in China

Our organization, along with our sister copyright organizations in the International Intellectual Property Alliance (IIPA), has been at the forefront of intellectual property negotiations between the United States and China since 1992, when a memorandum of understanding was signed obligating China to protect copyright in line with international standards at the time. We and our IIPA colleagues were again actively involved in USTR-led negotiations in 1995 and 1996 undertaken pursuant to Section 301 investigations, resulting in exchanges of letters obligating China to close factories producing and exporting pirate optical media product which were causing catastrophic disruption of our global markets. We and our colleagues were then heavily involved in a number of sectoral negotiations in connection with China's WTO accession, and supported the renewal of normal trade relations annually, and eventually permanent normal trade relations (PNTR). Each of these milestones has had significant commercial ramifications for the U.S. copyright industries.

Today, despite China's various bilateral and multilateral commitments to the United States, U.S. entertainment industries face four significant and related problems in China. A more detailed paper, submitted to USTR by IIPA as part of this year's Executive Branch review of China's implementation of its WTO obligations, is attached. The first of our ongoing problems was addressed by the 1995/6 Special 301 agreement, but is now reappearing. The others remain unaddressed major problems.

1. Chinese optical media factories in the past produced huge quantities of pirate CDs, much of which was exported throughout the world. This had been largely controlled subsequent to the 1996 US-Sino IPR agreement—but is now resuming. The Motion Picture Industry reports that pirated exports from China shot up from less than 0.5 percent of total seizures of pirated DVDs in 2002 to 12.1 percent in the first six months of 2003, based on data from the UK Customs. This sharp rate of increase is cause for alarm.
2. The Chinese internal market remains almost entirely pirate (at over 90%) despite many raids, seizures and administrative fines that are inadequate to deter continued piracy. Pirated music and motion pictures are produced in China or are imported from Hong Kong, Taiwan and elsewhere. Pirated music sales in China exceeded half a billion dollars in 2002.
3. Internet and broadcast piracy is growing rapidly in China. Many websites offer downloading of illicit music files and streaming of illicit movies. China-based ISPs have become online "warehouses" for international pirate syndicates. In addition, other distribution networks, including provincial and local broadcasters and cable systems, also routinely include unauthorized broadcasts of U.S. programs.
4. A Chinese labyrinth of market access and investment barriers prevent legitimate entertainment producers from serving the Chinese market in a timely manner, which perversely increases consumer demand for pirated product. A solution to piracy requires much greater progress on this issue.

China is currently the world's largest consumer of pirated products. Unless action is taken promptly, China may once again become the world's foremost producer of pirated materials as well.

The Solutions

1. Anti-piracy: China MUST criminally prosecute pirate producers, importers and distributors, as well as internet pirates and infringing ISPs. China remains among the last countries in the world that does not prosecute commercial pirates for criminal copyright infringement. As we have learned from years of experience in fighting piracy, without use of criminal sanctions, there is little likelihood that China can significantly reduce piracy rates. To do this, at minimum the following must occur:

- A nationwide initiative must be mandated as a Chinese national priority; a vice-premier should lead the campaign so that enforcers take it seriously.
- Pirates must be criminally prosecuted. Current reliance on administrative sanctions has failed as an enforcement tool.
- Criminally prosecuting pirates will require legal and administrative changes. For example, contrary to the practice in the U.S. and most other countries,

China does not permit private organizations like ours to conduct investigations in China. Yet China's Public Security Bureau—their police—has not been inclined to investigate either, leaving anti-piracy enforcement to administrative agencies, which have authority only to seize product and impose small, ineffective monetary fines. Private investigations to gather evidence must be permitted.

- The current law sets thresholds for initiating criminal investigations only if the pirate has revenues or profits in excess of specified levels as described in our attached documentation. "Revenue" is defined as the goods already sold, valued at pirate prices. Unsold seized pirate inventory is excluded. But revenues or profits are rarely possible to determine as pirates avoid record-keeping, and we are not permitted to undertake investigations that would assist the authorities. These thresholds must be reduced and redefined, for example, to permit unsold inventory to be counted and to establish whatever threshold is set by reference to the retail, not the pirate price.
- Another major problem is that Chinese Customs will not consider seized imported or exported pirate product to be "sold" goods, thus refusing to refer large seizures for criminal prosecutions. This relates directly to China's inability to address the renewed surge in pirated exports from China. Criminal prosecutions must be permitted for large Customs seizures.
- China committed in its WTO Protocol of Accession to address these problems, in part by reducing significantly the existing onerous thresholds for initiating criminal prosecutions. In fact, the TRIPS Agreement requires it. Yet China has not done so.
- The Chinese Supreme Court and State Council must issue new interpretations, guidelines and instructions to judges, prosecutors and the Public Security Bureau to permit private investigations, to lower the current onerous thresholds and to direct enforcement authorities to actively investigate and criminally prosecute copyright piracy, including certain Customs seizures. We understand the Supreme Court is considering new guidelines and interpretations along these lines. China committed to achieve this as part of the WTO accession. The US Government should press to make this happen.

2. <u>Market Access</u>

<u>Censorship:</u>

(1) Chinese government censors are required to review the content of only legitimate foreign-produced sound recordings before their release. Domestically-produced Chinese sound recordings are NOT censored. Of course, pirated product is not censored either. China should terminate this discriminatory process between imported and domestically-produced product.

(2) Censorship offices are woefully understaffed, causing long delays in approving new recordings. The best result would be for censorship to be industry-administered, as in other countries. If this is not possible, steps must be taken to expedite the process so that legitimate music and motion pictures can be promptly marketed, preventing pirates from getting there first. In the near-term, China should be pressed for a commitment to (1) end discrimination in censorship and (2) complete the approval process within a reasonable period (e.g. a few days). In the long-term, censorship should abolished.

- <u>Producing and publishing sound recordings in China:</u>

  U.S. record companies are skilled at and desirous of developing, creating, producing, distributing and promoting sound recordings by Chinese artists, for the Chinese market and for export from China. However, onerous Chinese restrictions prevent this from occurring. For example, for a sound recording to be brought to market, it must be released through an approved "publishing" company. Currently only state-owned firms are approved to publish sound recordings. China should end this discrimination and approve foreign-owned production companies.

  Further, production companies (even wholly-owned Chinese ones) may not engage in replicating, distributing or retailing sound recordings. This needlessly cripples the process of producing and marketing legitimate product in an integrated manner. China should permit the integrated production and marketing of sound recordings.

  U.S. record companies may market non-Chinese sound recordings only by (1) licensing a Chinese company to produce the recordings in China or (2) importing finished sound recording carriers (CDs) through the China National Publications Import and Export Control (CNPIEC). China should permit U.S. companies to produce their own recordings in China and to import directly finished products.

- Distributing sound recordings:

  Foreign sound recording companies may own no more than 49% of a joint venture with a Chinese company. However, the recently concluded "Closer Economic Partnership Agreement (CEPA)" between China and Hong Kong permits Hong Kong companies to own up to 70% of joint ventures with Chinese companies engaged in distributing audiovisual products. China should grant at least MFN status to U.S. record producers per the terms of the CEPA.

Conclusion

The piracy situation in China remains dire. Much more needs to be done by China in order for it to meet its TRIPS obligations in the area of copyright, both with respect to the TRIPS enforcement and substantive obligations. It is time for the Chinese government to acknowledge the nexus between practicable market access and the ability to effectively fight piracy. Piracy cannot be defeated or effectively deterred by enforcement alone—it must be accompanied by market-opening measures. Some of the necessary steps are reflected in China's WTO commitments. Others, such as allowing essential activities related to record production by foreign companies, have not occurred, but must begin to occur if China is to have any hope of effectively curtailing copyright piracy. The continuous vacuum left by China's closed market will always be neatly filled by pirates who, by the very nature of their illegal activities, do not adhere to legitimate market rules. We urge the United States and the rest of the international trading community to keep pressure on China through the WTO and other processes to provide a vehicle for opening the Chinese market to our products, and to more effectively combat copyright piracy.

Attachment

September 10, 2003

BY ELECTRONIC MAIL (FR0083@ustr.gov)

Ms. Gloria Blue
Executive Secretary
Trade Policy Staff Committee (TPSC)
Office of the United States Trade Representative
1724 F Street, N.W.
Washington, D.C. 20508

Re: Comments Regarding Intellectual Property Rights (Including Intellectual Property Enforcement), and Services/Market Access in China, in Response to the "Request for Comments and Notice of Public Hearing Concerning China's Compliance With WTO Commitments," 68 Fed. Reg. 43247–8 (July 21, 2003)

Dear Ms. Blue:

This filing responds to the Request for Comments and Notice of Public Hearing Concerning China's Compliance with WTO Commitments, appearing in 68 Fed. Reg. 43247–8 (July 21, 2003). The request invites comments on China's compliance with the commitments it made in connection with its accession to the World Trade Organization (WTO). Specifically, the Request for Comments notes,

> In accordance with section 421 of the U.S.-China Relations Act of 2000 (Pub. L. 106–286), USTR is required to submit, by December 11 of each year, a report to Congress on China's compliance with commitments made in connection with its accession to the WTO, including both multilateral commitments and any bilateral commitments made to the United States.

The Request for Comments states that "to assist USTR in preparing the report to Congress, USTR is hereby soliciting public comment," including on China's compliance with commitments in the area of intellectual property rights and services/market access that were made in connection with its accession to the WTO.[1]

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[1] The terms of China's accession to the WTO are contained in the Protocol on the Accession of the People's Republic of China (including its annexes) (Protocol) (WT/L/432, Nov. 10, 2001), at http://www.mac.doc.gov/China/ProtocolandDecision.pdf, the Report of the Working Party on

Continued

The International Intellectual Property Alliance ("IIPA") submits comments on key issues with respect to China's compliance with the TRIPS Agreement, and with respect to certain of China's other WTO commitments, particularly in the areas of services and market access. In order to provide a more detailed analysis of China's compliance with the substantive and enforcement obligations under the TRIPS Agreement, IIPA also takes this opportunity to append to this filing a report on China (see Appendix) that was submitted to the United States Trade Representative on February 14, 2003, as part of our filing in the annual Special 301 process.

A. IIPA AND THE COPYRIGHT INDUSTRIES' INTEREST IN THIS FILING

The International Intellectual Property Alliance (IIPA) is a private sector coalition formed in 1984 to represent the U.S. copyright-based industries in bilateral and multilateral efforts to improve international protection of copyrighted materials. IIPA is comprised of six trade associations, each representing a significant segment of the U.S. copyright community. These member associations represent over 1,300 companies [2] producing and distributing materials protected by copyright laws throughout the world ¾ all types of computer software including business applications software and entertainment software (such as videogame CDs and cartridges, personal computer CD–ROMs and multimedia products); theatrical films, television programs, home videos and digital representations of audiovisual works; music, records, CDs, and audiocassettes; and textbooks, tradebooks, reference and professional publications and journals (in both electronic and print media). Since 1984, this diverse range of industries has worked together, individually and under the IIPA umbrella, to strengthen the copyright laws and enforcement regimes in over 100 countries around the world. IIPA has also represented the copyright-based industries in the negotiation of key bilateral and multilateral agreements (including of course TRIPS) to raise international minimum standards of copyright protection and, of increasing importance, enforcement.

In April 2002, the IIPA released an economic report entitled *Copyright Industries in the U.S. Economy: The 2002 Report,* the ninth such study written by Stephen Siwek of Economists Inc. This report details the economic impact and contributions of U.S. copyright industries to U.S. Gross Domestic Product, employment, and trade. The latest data shows that in 2001, the U.S. copyright industries accounted for 5.24% of U.S. Gross Domestic Product (GDP), or $535.1 billion—an increase of over $75 billion from 1999 and exceeding 5% of the economy and one-half trillion dollars for the first time. In addition, over the last 24 years (1977–2001), the U.S. copyright industries' share of the GDP grew more than twice as fast as the remainder of the U.S. economy (7% versus 3%). Between 1977 and 2001, employment in the U.S. copyright industries more than doubled to 4.7 million workers, which is now 3.5% of total U.S. employment; and the U.S. copyright industries' average annual employment grew more than three times as fast as the remainder of the U.S. economy (5% versus 1.5%). Finally, in 2001, the U.S. copyright industries achieved estimated foreign sales and exports of $88.97 billion, again leading all major industry sectors, including: chemicals and allied products, motor vehicles, equipment and parts, aircraft and aircraft parts, and agriculture.

Specifically with respect to China, IIPA's members were at the forefront of discussions in 1992 that led to the signing of a Memorandum of Understanding between the United States and China. That MOU obliged China to protect copyright in line with international standards in place at the time. IIPA's members were again at the forefront of USTR-led negotiations in 1995 and 1996, resulting in exchanges of letters, by which China undertook to close down factories producing and exporting pirate optical media product with impunity (causing catastrophic disruption of global markets) and commence a nationally-coordinated enforcement regime for copyright protection. IIPA and its members were heavily involved in a number of sectoral negotiations in connection with China's WTO accession, and supported the renewal of normal trade relations annually, and eventually permanent normal trade relations (PNTR). Finally, IIPA and its members observed developments with great interest that led to China's entry to the WTO on December 11, 2001. Each of these

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the Accession of China (Working Party Report) (WT/MIN(01)/3, Nov. 1, 2001), at http://www.mac.doc.gov/China/WPReport11-10-01.pdf, and the WTO Agreement. Specific copyright commitments are made in Section 5 of the Working Party Report. Specific market access commitments are made in Report of the Working Party on the Accession of China, Addendum, Schedule CLII—The People's Republic of China, Part II—Schedules of Specific Commitments on Services, List of Article II MFN Exemptions (WT/MIN(01)/3/Add.2, Nov. 10, 2001), at http://www.mac.doc.gov/China/ServicesSchedule.pdf.

[2] This number is updated as of September 10, 2003.

milestones has had significant commercial ramifications for the U.S. copyright industries.

It is essential to the continued growth and future competitiveness of these industries that China provides free and open markets and high levels of copyright protection. China made commitments to open its market during the WTO accession negotiations, as well as the commitment immediately to comply with TRIPS enforcement and substantive standards, the legal foundation for adequate and effective substantive levels of copyright protection and copyright enforcement. Meeting these commitments is essential to the copyright industries' and individual authors/creators' abilities to do business in China.

B. SUMMARY OF CONCLUSIONS WITH REGARD TO CHINA'S WTO COMMITMENTS, AND PARTICULARLY, TRIPS COMPLIANCE

Our conclusion is that two primary problems have kept China's market largely closed and have prevented copyright owners from benefiting from China's accession to the WTO. The first is copyright piracy, which dominates the local market for copyrighted materials and, as in the 1990s, is beginning to become an export problem again. The second is market access restrictions which further exacerbate and limit the ability of Chinese authorities to tackle the piracy problem. It is only through steps designed to deter piracy, including lowering the threshold in order to bring criminal actions in China against copyright piracy and commencing coordinated efforts to enforce against all forms of piracy, combined with steps to open the Chinese market, that China can hope to meet its WTO commitments. The Appendix notes other continued TRIPS deficiencies, both substantive and enforcement-related, that China must address to fully comply with TRIPS.

One of the goals of the accession process with China was to ensure the immediacy of China's obligations to comply with TRIPS substantive and enforcement obligations.[3] This was achieved upon China's accession to the WTO on December 11, 2001. China also agreed to meet various schedules with respect to other commitments, including services and market access commitments for U.S. companies/service suppliers, that are the subject of comments below.

Before 2000, many countries had successfully amended their statutory law to bring them into compliance (or close to compliance) with their TRIPS obligations. China's outdated 1990 law had been supplemented by "International Treaties Regulations" in 1992 which satisfied some TRIPS requirements, but it was not until October 2001 that China revised its law with the intent to comply with all substantive requirements of TRIPS.[4] Unfortunately, certain problems remained even after the amendments, and subsequent regulations (computer software regulations and new implementing regulations to the copyright law) contained further problems.[5] Even

[3] The TRIPS Agreement had already entered into force for the U.S. (and for all other WTO members that did not qualify for and take advantage of transition periods) on January 1, 1996, and even for WTO members that qualified for a transition period, the national treatment and MFN provisions of TRIPS applied fully as of January 1, 1996 (TRIPS, Article 65.2 provides that "any developing country member is entitled to delay for a further period of four years [following the expiration of the one year period after the entry into force of the WTO generally] the date of application, as defined in paragraph 1 above, of the provisions of the Agreement other than Articles 3 [and] 4 . . . of Part I"; Articles 3 and 4 establish the national treatment and MFN obligations of the Agreement). On January 1, 2000, all TRIPS copyright obligations, including providing adequate enforcement procedures and effective remedies to deter piracy, entered into force for all the world's developing countries (except those classified by the U.N. as the "least" developed countries, which have until January 1, 2006 to comply).

[4] Copyright Law of the People's Republic of China, Adopted at the Fifteenth Session of the Standing Committee of the Seventh National People's Congress on September 7, 1990, Amended in Accordance with "Decision to Amend Copyright Law of the People's Republic of China," Adopted at the Twenty-fourth Session of the Standing Committee of the Ninth National People's Congress on October 27, 2001 (translation on file at IIPA).

[5] We are disappointed that the Implementing Regulations (September 15, 2002) did not take steps to come into full TRIPS compliance. For example, the regulations significantly weakened the fine provisions, by changing the calculus of fines in the vast majority of cases (by the use of the term "three times the revenues," which could be higher than the previous maximum monetary fine but will be very difficult to prove) and by removing certainty as to the maximum administrative fine (which under the old Regulations was up to roughly US$12,000). The Implementing Regulations also leave in place a compulsory license that, with respect to U.S. and other WTO members' subject matter, clearly violates TRIPS. It is disappointing that the Chinese government did not clarify that those provisions do not apply to foreign right holders in order to meet China's TRIPS obligations. The implementing regulations further failed, among other things, to clarify whether temporary copies are protected. They also fail to clarify that the reproduction right in Article 41 for sound recording producers extends to indirect reproductions, as

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more important, however, is compliance with TRIPS enforcement obligations (Articles 41–61), and China's record has been disappointing and accounts for the steady high levels of piracy and the billions of dollars in losses suffered by copyright owners. It is the promise of these new enforcement obligations that is essential to returning the commercial benefits that were envisioned at the conclusion of the Uruguay Round. China must therefore begin to demonstrate that its enforcement system is, in practice, effective in deterring piracy.

C. PIRACY AND CHINA'S RESPONSES IN 2003

The market in China remains dominated by piracy. Piracy levels (which reflect the percentage of product sold in a market that is illegal) remained at 90% or above in 2002 for all copyright industries; the Chinese enforcement system has failed to lower such piracy levels, and therefore, it cannot be said to provide adequate procedures and effective legal remedies to protect copyright, as is required by the TRIPS enforcement provisions . Estimated losses due to piracy of copyrighted materials (excluding entertainment software) were over $1.8 billion dollars in 2002. This combination of debilitating levels of piracy and huge economic losses to America's creative industries serves as a tremendous *de facto* barrier to entry into the Chinese market for U.S. firms.

Optical media plants in China continue to produce pirate CDs, VCDs and DVDs, and there is increasing evidence that pirate producers in China have once again begun exporting product out from China.[6] Imports of pirate product from other territories in Asia remain a most significant problem.

Internet piracy is an ever-growing phenomenon in China today (including Internet piracy at Internet cafes).[7] The rise of websites like listen4ever.com and chinamp3.com in recent years, which were giving away pirate MP3 files of whole songs or even trying to sell them, indicate that the convergence of a growing young consumer base in China and technologies like those employed in digital networks is causing increasing problems for copyright owners in China. While China has to date done a commendable job in trying to halt illegal activities over digital networks, it is quite disappointing that the latest law in conjunction with the new implementing regulations failed to solidify the legal framework necessary to protect copyright on the Internet.[8] We understand that China is now reviewing the 2001

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required by TRIPS. The Computer Software Regulations (effective January 1, 2002) also contained many problems and deficiencies discussed in detail in the Appendix. For example, the Regulations failed to clarify whether temporary copies (of computer software) are protected. The Regulations also established a huge, TRIPS-incompatible exception to protection for software that goes well beyond what is permitted under the Berne Convention and TRIPS, as it may permit reproductions or other exercises of exclusive rights without authorization (such as in the context of reverse engineering). The Regulations further create a huge loophole allowing corporate end-user piracy, providing that the possessor of infringing software is relieved of liability if the possessor is ignorant, or reasonably ignorant, of the infringing nature of the software. This is inconsistent with the copyright law as amended, which puts the burden of proof in such cases of infringement on the possessor. If this exception is abused, it would so weaken enforcement against corporate end-user piracy that it would amount to a violation of TRIPS Article 41. The same exception also may extend beyond what is allowed by TRIPS by establishing a compulsory license (i.e., the remedy may be limited to paying a license fee) that directly conflicts with the normal exploitation of the work and the legitimate interests of right holders. The normal damages provision of the law should govern in these cases. These problems and others are detailed in the Appendix.

[6] As examples of anecdotal evidence, IIPA knows of one seizure by Hong Kong Customs on June 10, 2003 in which over 5,000 pirated DVDs were seized in a transshipment originating from Fuzhou, China. In another example, on June 6, 2003, Macau Customs intercepted a suspected shipment from China, seizing almost 13,000 optical discs including 3,600 VCDs, 3,200 DVDs and more than 5,000 music CDs.

[7] The Chinese government has recently directed greater attention on the activities occurring at Internet cafes. While content blocks (i.e., on pornography, news sites, and the like) have been commonly required in such premises, less attention has been paid to possible infringing uses of copyrighted materials, including illegal uses of pirated entertainment software. IIPA hopes the Internet regulations will address this legal deficiency and ensure that Internet cafes strictly adhere to the copyright law, including ensuring that its customers do not engage in the unauthorized use of copyrighted materials, including entertainment software products.

[8] The tools are largely in place for the Chinese government to take down illegal websites and prosecute their operators. However, such vital protections, for example, protecting temporary copies as reproductions, are missing from China's copyright law. Also, while the copyright law established some legal tools to go after the manufacture of certain devices that circumvent technologies used by copyright owners to protect their works in the online environment, those provisions did not go far enough. It is disappointing that the latest implementing regulations did not cure these deficiencies. We note that the Chinese further failed to take this legislative opportunity to fully modernize their law. We note with great disappointment that the amendments did not take advantage of the opportunity to extend terms of protection to life plus 70 years

Internet regulations, and we look forward to reviewing the draft Internet regulations expected to be issued in late 2003. We urge the U.S. government to seek an opportunity for transparent review of these important Internet regulations prior to their issuance.

For the business software industry, unauthorized copying within companies and government entities in China causes the greatest losses to that industry. As with all of the other copyright industries, the criminal and administrative systems have not been effective in curbing this problem, and civil redress has also proved to be ineffective against enterprise end user piracy due to the reluctance of courts to issue preservation orders. There is no effective administrative enforcement system against end user piracy of software (corporate end-user piracy) and other copyrighted materials in China. The Chinese government has issued Decrees and Orders to the local copyright administrations to investigate end-user piracy, but they have failed to self-start such efforts without the filing of complaints from copyright owners. Simply put, the National Copyright Administration has not demonstrated that it has the political mandate, resources and experience to address the end-user piracy problem. This failure to address end-user piracy implicates China's compliance with its TRIPS obligations. Finally, to our knowledge, very few court-ordered preservation measures under TRIPS Article 50 have been carried out in practice.

Piracy affects the markets for every copyright sector, including movies, recorded music, business software, entertainment software, and book publishing. Pirate versions of the newest Harry Potter book,[9] and the latest first-run motion pictures, for example, *Uptown Girls, Freddy vs. Jason, American Wedding 2003* and *Pirates of the Caribbean,* continue to decimate the markets in China for those products. Even local Chinese directors such as Zhang Yimou have struggled against piracy in China to attempt to secure a decent return on their investments.[10]

Book publishers have experienced four major problems in 2003 that are worthy of note: (1) continued, unabated piracy of higher education textbooks; (2) illegal/unauthorized downloads of online journals and other materials; (3) an increase in pirated translations undertaken by so-called "secondary channel distributors"—often small, private entrepreneurs who distribute books outside the normal state run distribution channels; and (4) counterfeiting of well-known publisher trademarks and unauthorized use of well-known authors' names and trade dress.

A crucial TRIPS deficiency in the Chinese legal system remains the excessively high thresholds set for bringing criminal actions. The high thresholds translate to difficulties convincing Chinese authorities to prosecute commercial piracy cases under the copyright provisions of the Criminal Law. Article 41 of TRIPS requires countries to provide "effective action" against infringements that actually creates a "deterrent to further infringements." Article 61 of TRIPS requires that criminal procedures be available (in practice) against copyright piracy "on a commercial scale." While there were several successful criminal prosecutions for piracy in 2003, those mainly involved local right holders. One very recent conviction in Shanghai involving U.S. motion picture product resulted in strict penalties being meted out against several defendants. However, that prosecution was brought for commission of a crime other than criminal copyright infringement—for 'illegal business operations'—so while the result was very positive, it does not go to satisfy China's TRIPS obligations, since Article 61 of TRIPS requires China to provide a criminal remedy at least in cases of commercial copyright piracy. Simply put, thresholds for bringing criminal actions against those committing acts of copyright piracy must be lowered. The State Council, in the WTO Working Party document, has promised to recommend to the Supreme People's Court that it lower thresholds for bringing criminal actions;

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and 95 years from publication. This is the modern trend. A full right of importation applicable to both piratical and parallel imports should also have been included. Greater discussion of these points can be found in the Appendix.

[9] Satoshi Saeki, Harry Potter latest victim of China's lucrative piracy mart, Yomiuri Shimbun, August 9, 2003.

[10] A Shanghai Daily article from January 18, 2003 documented the fruitless efforts of famed Chinese director Zhang Yimou and efforts to protect his latest film *Hero.* On January 8, 2003, a cinema in Xi'an reported losing a print of the film. The police cooperated and interviewed the theater's employees, one of whom killed herself by jumping off a building. Then low-quality copies started showing up on the street. The legitimate DVD distributor then violated his contract with the film's distributor and began selling pirate DVDs before it was authorized to begin legitimate distribution on February 20, and in a low-quality, cheap format to compete with the pirates. An article appeared in the New York Times on November 1, 2002 regarding this struggle for Mr. Zhang. In that article, the head of New Pictures (the distributor of *Hero*), Jiang Wei, said, "[a]fter the release [of a film], we often have only three days before the pirate copies hit the market . . . The industry can't survive that." Another Chinese film, *The Touch,* starring famed Michelle Yeoh, was available on pirate DVDs four days after the film's release, "and ticket sales slid fast." *See* http://nytimes.com/2002/11/01/business/01PIRA.html.

in addition, administrative fines must be raised, to make such actions truly effective and sustainable.

For foreign right holders, enforcement in 2003 continued to involve mostly administrative enforcement actions, chiefly aimed at seizing infringing materials, but such efforts remain largely *ad hoc* and lack coordination. Administrative enforcement has generally been an ineffective basis for enforcement in China, since administrative cases result in notoriously low fines, no imprisonment, and thus no real deterrence to further piracy. For example, one entertainment software company reports that some Chinese factories engaged in the illegal manufacture of counterfeit entertainment software products have been able to continue their operations even after their premises have been raided and infringing goods seized. In addition, shutting down a factory often does not deter further piracy, since in many instances, the same entity merely shifts operations to another location under a different corporate name.[11] The Chinese government must carry out criminal investigations, focusing on organized criminal operations such as those mentioned, and must initiate prosecutions with deterrent penalties against egregious pirates in order for China to meet its TRIPS enforcement obligations.

D. MARKET ACCESS: A NECESSARY INGREDIENT TO FIGHT PIRACY IN CHINA

Providing market access to allow more legitimate product into China is an essential element of an effective anti-piracy strategy in the country. It is significant that China, through its WTO commitments, has agreed to open its market in various ways to different copyright industry sectors. For example, it is noteworthy that China has agreed to open its market to wholesale and retail distribution by foreign book publishers. Other commitments, particularly in the audio and audiovisual sectors, are less helpful, but as minimum commitments, it is possible for China to effectuate further market opening at any time. It is now of paramount importance that the U.S. government work to secure the commitments made through any necessary changes to China's legal system, and to ensure that the gains that were promised are not stymied by continued restrictive commercial practices in China with respect to publishing. It is also equally important for the U.S. government to continue to press for greater market opening, since it is only with market opening that the problems of piracy can be addressed in a fundamental way.

For example, policies such as China's WTO commitment to allow in a minimum of 20 films annually under standard commercial terms (revenue sharing) essentially provide pirates with a monopoly in the Chinese market for the six-month period between theatrical release of a motion picture and the release of the product in home video formats. If delays are permitted to occur in the censorship process for home video entertainment, then pirates have an even longer period in which they can operate before legitimate product enters the market. For other industries, for example, the book publishing industry, the WTO commits China to gradually open retail (beginning in December 2002) and wholesale distribution to foreign entities (both without restrictions except as to "chain" retail stores no later than December 2004). Unfortunately, continued severe restrictions on related activities, such as importation (which remains "prohibited") and printing (which is "restricted") call into doubt whether China can meet its WTO obligations (to allow unfettered distribution) under the current system.

The record industry faces serious market access hurdles (for every essential activity to their business in China) that result in limiting China's ability to effectively fight piracy.[12] The WTO commitments oblige China to open wholesale and retail distribution to foreign [record] companies in contractual joint ventures with Chinese

[11] For example, in October 2002 and January 2003, Chinese administrative agencies raided the "Electronic Dragon" production facilities at which over 49,000 counterfeit *Game Boy Advance* cartridges and components were confiscated. During post-raid surveillance, the company found that the factory had resumed operations in a different location under a new company name. A subsequent raid on the new location was conducted in July 2003 and more than 78,000 counterfeit Game Boy Advance cartridges and semiconductor chips were seized. The principals all fled China and authorities have been able to take no further action against them. Such actions by the pirates and difficulties enforcing against them indicates how well-developed and sophisticated these manufacturers and distributors have become. Such organized criminal behavior demands a coordinated national response from the Chinese government.

[12] For a more detailed account of the serious market access problems faced by the recording industry, we refer you to the comments of the Recording Industry Association of America (RIAA), which were filed on September 9, 2003, in response to 68 Fed. Reg. 43247–8 (July 21, 2003).

firms (but not wholly-owned foreign entities).[13] Other essential activities such as the signing of recording artists, artist management, and producing sound recordings, are not covered in WTO commitments. Chinese guidelines make it clear that "publishing, producing, master issuing and importing" of records in China are prohibited foreign investment activities, as is broadcasting,[14] while distributing and selling records is a "restricted" activity. In practice, certain "cooperative" agreements (not joint ventures) may allow foreign entities to publish and produce in China, and foreign entities may also apparently sign and manage artists as long as they have proper permits (again, the WTO commitments do not appear to cover these activities). Nonetheless, the overall restrictive nature of the recording business in China makes it impossible for China to effectively enter the market, and thus, fighting piracy of foreign content is virtually impossible. More important to the Chinese people and the Chinese economy, failure to open the Chinese market to those with the bulk of the wherewithal and know-how to make records makes it impossible for the vast majority of record producers worldwide to bring local Chinese content to the Chinese people and to make those artists and the music known to the world.

For publishers, the WTO Working Party Report, while it fails directly to address the permissibility of certain core activities carried out by foreign publishers, does set forth China's commitments with respect to the distribution of books, newspapers and magazines. The "Schedule of Specific Commitments on Services" attached to the Working Party Report defines "Distribution Services" to include wholesale services, retail services, as well as commission agents' services, franchise services and the like. With regard to "Distribution Services,"[15] China has committed to allow "foreign service suppliers" to "engage in the [wholesale] distribution of books, newspapers, [and] magazines" without market access restrictions no later than December 11, 2004, which is "three years after China's accession." By that time, there must also be no restrictions on foreign majority ownership and no geographic or quantitative restrictions.[16] With regard to "Retailing Services," China committed that "[f]oreign service suppliers will be permitted to engage in the retailing of . . . books, newspapers and magazines within one year after accession," or December 11, 2002. There are various geographic and equity ownership limitations in place until December 11, 2004, at which time all restrictions on commercial presence are lifted except as to "chain stores."[17] In addition to the specific commitments on wholesale and retail distribution, immediately upon accession (December 11, 2001), "[f]oreign-invested enterprises" are permitted to distribute (both wholesale and retail) their products (including those listed in the commitments, which include books, newspapers and magazines) as long as they are "manufactured in China." Both wholesalers and retailers may also, as of the date of China's accession, December 11, 2001, "provide the full range of related subordinate services . . . for the products they distribute."[18]

[13] World Trade Organization, Report of the Working Party on the Accession of China, Addendum, Schedule CLII—The People's Republic of China, Part II—Schedules of Specific Commitments on Services, List of Article II MFN Exemptions, WT/MIN(01)/3/Add.2, Nov. 10, 2001.

[14] The chief piece of legislation governing the record industry in China is the Administrative Regulations on Audio-Visual Products, State Council Order No. 341, Approved December 12, 2001 at the 50th session of the State Council s Standing Committee, signed and promulgated December 25, 2001 by Premier Zhu Rongji, and effective from February 1, 2002).

[15] "Distribution Services" are defined in Annex 2 of the Working Party Report, which is adopted from Annex I of the Agreement on Market Access Between the People's Republic of China and the United States of America, Nov. 15, 1999 ("China-US Market Access Agreement").

[16] Restrictions on foreign majority ownership and geographic and quantitative restrictions will be lifted on December 11, 2003. Therefore, foreign service suppliers of books, newspapers and magazines will have unfettered access to the wholesale distribution market by December 11, 2004, when China is committed to lift market access limitations to such foreign service suppliers. In the China-US Market Access Agreement, China also agreed that "[s]tarting no later than January 1, 2003 there will be no restrictions on equity/form of establishment" with respect to commission agents' and wholesale trade services. That commitment does not appear expressed in the Working Party Report, and we are interested to know whether this omission has a material impact on publishers (we suspect that the lifting of limitations on restrictions on foreign majority ownership may obviate the need for a separate provision regarding "equity" restrictions).

[17] The term "chain stores" is defined as stores "which sell products of different types and brands from multiple suppliers with more than 30 outlets." For those stores, foreign majority ownership will not be permitted if they sell, among other products, books, newspapers, and magazines.

[18] The "subordinated services" are defined in Annex 2 of the Working Party Report Addendum as including "inventory management; assembly, sorting and grading of bulk lots; breaking bulk lots and redistributing into smaller lots; delivery services; . . . storage, warehousing and

Continued

These market opening commitments for the distribution of published materials are extremely important, but they do not address core activities carried out by publishers, except in an ancillary way.[19] One crucial question left unclear in the WTO commitments is whether the commitments allow foreign entities to "import" published materials into China for distribution. Such activities are apparently not permitted at all according to China's current legal framework. While the word "importation" is absent in describing the activities to be permitted under the WTO commitments, the additional commitment allowing an FIE to immediately (upon accession) distribute books "manufactured in China" seems to imply that the phase-in commitments refer to other books, namely, books that are not manufactured in China—imported books. We urge the U.S. government to continue its vigilance in seeking greater market opening for U.S. publishers to engage in publishing activities (including printing, reproduction, binding and other manufacturing activities) in China, as well as the importation into China of published materials.[20]

E. SOME PROGRESS NOTED IN 2003 IN CHINA

Despite the many problems and deficiencies in the enforcement system, the Chinese government remains serious about reducing piracy and government ministers appear to be sincerely concerned about the problem. Indeed, Chinese government officials have admitted in recent years that piracy is serious, and both the problem and the government's awareness of it have been reported in the Chinese press.[21] Periodic crackdowns during 2002 and 2003 have resulted in seizures of tens of millions of pirated products. In addition, between January 1, 2002 and July 31, 2003, 18 VCD/DVD factories (2 of which were registered) were raided, yielding seizures of 45 VCD/DVD production lines. Regarding retail raids, the Ministry of Culture has stated that more than 5,000 retail shops were raided nationwide from January 1, 2002 to July 31, 2003. The seizure numbers indicate both the resolve of Chinese authorities to continue trying to rid the markets of some product, but also the sheer magnitude of the problem and how it will be impossible for the Chinese government to rid the market of piracy based on periodic anti-piracy campaigns and without a more coordinated, sustained effort.

We also acknowledge some progress in the area of publishing. Through immediate implementation of a State Council Decree issued in late 2001, the pirating of academic journals has been largely diminished. As a result, foreign publishers have been able to negotiate arrangements with customers to legitimately purchase or license use of academic journals. This positive development is an excellent example of how the Chinese government can open a market that was previously closed due to piracy, through central government will to address the problem—in this case, academic journals piracy.

China should further be acknowledged for the continued development of the specialized IPR courts. These courts handling IP cases in China continue to mature in their expertise of copyright issues and appear to be working well in deciding copy-

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garage services; sales promotion, marketing and advertising . . . and after sales services including . . . training services."

[19] For example, the commitments indicate that "foreign-invested enterprises" (FIEs) may distribute books "manufactured in China" upon the date of China's accession. This clearly means a foreign distributor can sell Chinese books, but a respectable argument might also be that a foreign distributor might be able to engage a Chinese printing house to run a printing of copies of books in China in order to distribute them in China.

[20] In particular, we note that current Chinese law is ambiguous as to what foreign entities may and may not do. Recent Administrative Regulations on Publishing appear to permit foreign entities to apply to engage in certain activities related to publishing and the U.S. government should confirm what activities are permitted and what activities remain restricted or prohibited and how those restrictions or prohibitions operate. It may be that the Regulations must allow foreign entities to engage in certain publication activities in China in order for China to meet its WTO services commitments. The U.S. government should further seek to lift ownership/equity restrictions for "publication importing entities" since the inability to import could directly or indirectly impair a foreign entities' ability to distribute wholesale and/or retail in China.

[21] *See, e.g.,* Weifeng Liu, *42 Million Discs Smashed in Nationwide Crackdown, Guangdong Key Target in Drive Against Audiovisual Smugglers,* China Daily, August 13, 2003 (in which Gui Xiaofeng, Deputy Director of the Press & Publications Administration and Deputy Commissioner of the National Anti Piracy & Pornography Working Committee said that pirated products have become a big problem for China, adding that the smugglers were not only breaching China's copyright laws but are also tax evaders); *see also Copyright Law Solid But Needs Fortifying,* China Daily, Sept. 14, 2000, at http://search.chinadaily.com.cn/isearch/i_textinfo.exe?dbname=cndy_printedition&listid=15654&selectword=COPYRIGHT%20PIRACY (quoting then National Copyright Administration Commissioner Yu Youxian as saying that the Copyright Law in China needed amending because "[a]nti-piracy regulations are not strong enough, since piracy was not serious when the law first took effect," and that "more provisions must be added because piracy has become rampant [in China] today").

right cases.[22] In the most recent cases, relatively large civil damages were awarded to foreign plaintiffs for infringement of plaintiff's copyrighted materials, in addition to the court enjoining further infringement and requiring the defendants to issue public apologies and be subject to severe sanctions if they repeated the infringement. We are also pleased to be able to report that foreign copyright owners are receiving good cooperation from government and judicial authorities in bringing civil cases. They are also receiving positive press regarding their actions against alleged infringers. These developments are noted by those on the ground in China as fundamental changes in the legal landscape in China since it joined the WTO.

F. CONCLUSION

Despite enormous seizures of pirate product, periodic "campaigns" by local governments against piracy, and progress noted against journals piracy and in the courts as noted, the piracy situation in China remains largely unchanged in 2003; in other words, it remains dire. We conclude that much more needs to be done by China in order for it to meet its TRIPS obligations in the area of copyright, both with respect to the TRIPS enforcement and substantive obligations. With the timetable for China's other WTO commitments (as distinguished from its TRIPS commitment which was immediate upon accession to the WTO) drawing close, the time is now for the Chinese government to acknowledge the nexus between practicable market access and the ability to effectively fight piracy. Piracy cannot be defeated or effectively deterred by enforcement alone—it must be accompanied by market-opening measures. Some of the necessary steps are reflected in China's WTO commitments. Others, such as allowing greater distribution of motion pictures in China by foreign companies, or allowing essential activities related to record production or book publishing by foreign companies, have not occurred, but must begin to occur if China is to have any hope of effectively curtailing copyright piracy. The continuous vacuum left by China's closed market will always be neatly filled by pirates who, by the very nature of their illegal activities, do not adhere to legitimate market rules. We urge the United States and the rest of the international trading community to keep pressure on China through the WTO and other processes to provide a vehicle for opening the Chinese market to copyright, as a necessary step in also achieving improvements in the enforcement environment.

IIPA appreciates the opportunity to provide its views on China's compliance with its obligations under the WTO and the TRIPS Agreement in the area of copyright. We look forward to our continued work with USTR and other U.S. agencies to bring about major improvements in copyright protection and enforcement worldwide.

Respectfully submitted,

Eric H. Smith
President, International Intellectual Property Alliance

Mr. PORTMAN. Thank you, Mr. Papovich. I want to thank all the witnesses for their valuable input this morning. I would like to ask Mr. Crane, who is Chairman of the Subcommittee on Trade, to begin the questioning, and then to our Ranking Member this morning, Ms. Tubbs Jones. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman. Mr. Malpass, you state that you expect robust job growth in 2004. What factors are contributing most to that positive forecast, and how many jobs do you expect to be created in the next 12 months? Could you also comment on yesterday's GDP release?

Mr. MALPASS. Yes, sir, Mr. Crane. In the third quarter, the GDP grew 7.2 percent. The nominal GDP, which is the basis for

[22] For example, on March 24, 2003, the Shanghai No 2 Intermediate People's Court ordered three copyright violators to pay a combined 500,000 Yuan (US$60,241) in compensation to the Shanghai Lexicographical Publishing House for pirating "Cihai," the most popular encyclopedia in the Chinese language. Some recent cases involved uses of copyrighted works in the digital environment, and were decided in accordance with the laws and with reasoned decisions in writing. *See, e.g., Guangdong Taixin Co Ltd. v. EMI (HK) Group Ltd.,* Guangdong Province People's High Court Civil Judgment (2001, Guangdong Province People's High Court IP Case No. 153).

profits within the economy, grew even faster, at 8.9 percent. This is a breakout for the economy.

It showed up in small business profits, which grew in the same quarter at over 12 percent, which is the highest rate of growth since 1997. Small businesses within the economy are doing much better than they were in the recession. That then leads or points toward job growth going forward.

In my view, the reason that we didn't have job growth in the last 2 years was twofold: one, we had a huge amount of employment in the late 1990s. To an extent, it was a boom of employment that went along with the dot com boom. The unemployment rate went to 3.8 percent, which was unsustainable. So, part of the reason there hasn't been job growth so far, or not much yet in the recovery, is because it was such a low unemployment rate going in; and the second reason is because inventories have continued to be drawn down. Big businesses are simply not participating yet in the expansion. So, my optimism for the next year—I think we will see 4-percent growth or more in 2004—is that small businesses—are the engine of the U.S. economy and will be able to drive it forward.

You asked how many jobs. Job growth, I think, can move to the 200,000 per month level. So, if we multiply that by 12 months, maybe we will see 2 million jobs created. People are making a big deal of this number of job losses since the peak, but remember where we still are. We are at 130 million people employed in the U.S. economy, which is very high by historical standards; and I think we will go higher than that in 2004.

Mr. CRANE. This is a question for anyone who wishes to respond. I had the privilege of visiting Korea earlier this year and touring our Hyundai facilities over there, watching the construction of those automobiles, and they have totally robotized their construction. The only human beings I saw were people waiting for cars coming off the production line at the end to take them out and park them.

That is a thing that is happening, and that does have a profound impact on employment in the manufacturing industry. Is this something that you folks anticipate could escalate? They said the reason for robotization was better quality control than when you had humans assembling the cars.

Mr. JARRETT. You have much the same impression if you went into a very advanced wafer fab facility making chips. Our new factories here in the United States, the number of people walking around, is much smaller than it was in the past. The chips move in self-contained things that are just moving around by robots throughout the factories, so it never was labor intensive. It is less labor intensive now, so again it is a matter of quality.

Mr. CRANE. One final question, and that is a recent national association's study indicated that several domestic economic factors, including health care costs, taxes, and energy costs, have had a major impact on the competitiveness of manufacturers in the United States is that something you share the view of?

Mr. DEVOS. I would speak for ourselves and say other things out there would be the abuse of the legal system. That happens to continue to add cost to and impact our competitiveness.

Mr. O'HAGAN. Mr. Crane, that is absolutely true, also, in the electrical industry. All of these factors I mentioned in my statement are contributing to the non-productive costs, which really put us at a disadvantage.

Mr. CRANE. Thank you all very much.

Mr. PORTMAN. Gentlelady from Ohio, Ms. Tubbs Jones.

Ms. TUBBS JONES. Thank you, Mr. Chairman. Mr. Jarrett, one of the statements you made was that one of the most important things that we can do is an emphasis on fixing our K through 12 system, with a special focus on improved math and science. I would ask you: would you be willing to forgo some of the tax benefits that you are receiving in order to fund No Child Left Behind (P.L. 107–110) so that some of the children across this country could in fact receive some of the educational benefits that you have spoken about?

Mr. JARRETT. Well, I think that is a convenient kind of choice to make, but the fact is we think the education is important. It needs to be funded. Most of that funding—as you know, only 7 percent of the funding for K through 12 education is at the Federal level.

Ms. TUBBS JONES. I do not need you to educate me on how education is funded by the Federal government. My question is simply: would you be willing to forgo some of the tax benefits that you were proposing in order to fund children's education in the United States? Yes or no?

Mr. JARRETT. Let me respond and say we do not think that is a choice that necessarily has to be made.

Ms. TUBBS JONES. In fact, it may well be because of the deficit that we are facing in this country, and it is a choice of either giving tax benefits or funding education, basically. Since you do not want to answer my question directly, I just want to put it on the table with you so we could deal with it.

Let me raise another question with you, Mr. O'Hagan. Let me for the record say I am a trial lawyer by background, and I believe in and oppose tort reform. I believe that many other benefits that workers have received in this country have come by way of litigation, so I must say that the social costs—I do not know what your fathers did in terms of work, but my dad worked for United Airlines and carried bags for 30 years; and it was only because of the hard work and the benefits he received in his job that he was able to educate his three daughters and send them to college.

Now the reality is that we operate in a country wherein the labor benefits have been better and actually have raised the bar for developing countries across the world. My question to you is: shouldn't it be that we would want to raise the bar in other countries, rather than lower the bar in support for workers in this country, in order to improve the economics and the industry across the country?

Mr. O'HAGAN. I would agree absolutely. The point I was making is that these social costs are costs that we have to bear that others do not. We are not saying they are bad and it is the right thing to raise our standard of living, to improve our environment, but in the process of incurring those costs, we are at a disadvantage. In time, the other countries will start to incur those costs, as they should, for the benefit of their citizens.

Ms. TUBBS JONES. Thank you. Mr. Kruse, you stated that the middle class in China, in 1994, there were 100 million. What is middle class, in terms of income for China?

Mr. KRUSE. Well, I cannot give you a specific number, but what we are talking about by middle class is people in China who have disposable—who have reached the level of income that they had.

Ms. TUBBS JONES. Well, what is it? How can you use the term middle class and say to me there are 100 million and half a billion Chinese who are middle class and you cannot tell me what that income is?

Mr. KRUSE. Well, I think the important thing is, by definition, it is people in China in this case that have the ability to purchase goods that they choose. There is an interesting——

Ms. TUBBS JONES. Well, let's contemplate this: how many people are there in China, sir?

Mr. KRUSE. A whole lot, several billion.

Ms. TUBBS JONES. So, in terms of relativity, as compared to the people in the United States, in light of the fact that you cannot give me a number for what that income is, it may be—middle income in China could be $6,000 income, because people in China work for 60 cents an hour.

Mr. KRUSE. And——

Ms. TUBBS JONES. I do not mean any offense, sir, but I am trying to put a perspective on what you are telling me, where half a billion people in China are going to be middle income by 2012.

Mr. KRUSE. Sure, and I think the important point again is people's ability in the country in which they live. In this case, the Chinese, have the ability—Congressman Crane is talking about automobiles. The automobile, the sale of automobiles in China, has exploded over the last couple of years. It is the ability of people to make choices and be able to purchase what they choose, and I think it is very important to all of us testifying this morning, it is all important to all of us that the middle-class people in China, the people who have the ability to choose and make purchases, is growing at an astronomical rate.

Ms. TUBBS JONES. Let me just end with this question: I would appreciate a follow-up response from you, Mr. Kruse, as to what you mean by middle class. What were the dollars? It is important for people who are listening across the country to understand what you mean by middle class as compared to middle class in the United States. I would appreciate a written response from you on that issue. Mr. Chairman, I know my time is up, and I thank you for the opportunity.

[The information follows:]

In answer to your question at the Committee's hearing on U.S.-China Economic Relations on Friday, October 31, 2003, I am pleased to provide the following information in response to your inquiry. Your question was, "what is the definition of "middle class?" You amplified your question by requesting information about the definition and a comparison of "middle class" in China relative to "middle class" in the U.S. The questions followed my parenthetical remark that China's middle class is forecast to grow to several million people in the next few years.

In China, there is great debate about the term "middle class" because it carries with it connotations of a social class that fosters democracy and of a political structure that is very similar to Western democracies. The preferred term in China is "middle income earners" because it succinctly describes an income level. This controversy points out one significant difference between these demographic groups in each country. China hasn't truly determined how to deal politically with this growing affluence yet while in the U.S., the middle class is the economic and political foundation upon which the U.S. is crucially dependent. Other terms for middle class in China include "white collar" or "middle part of society."

While no official definition exists in China of middle income earners, unofficially the Chinese Academy of Social Sciences defines them as those who earn between U.S. $2,500 and U.S. $10,000 per year. Unofficially, they indicate that about 15 percent of the Chinese population, or between 65 million and 100 million people reach this level. An official from the State Information Center forecasts that China will have 200 million middle income earners by the end of 2005 and China's chief WTO negotiator forecasts 400 million to 500 million middle income earners within 10 years. The State Information Center further defines middle income earners as those who can afford to buy cars and housing, and spend money on leisure travel.

Again, I hope this responds to your inquiry. Should you have additional questions or comments, please feel free to contact me.

Mr. PORTMAN. Thank you, Ms. Tubbs Jones. The gentleman from New York, Mr. Houghton.

Mr. HOUGHTON. Thank you, gentlemen. Thank you very much for being here. When we talk about China, we are talking, really, about the United States. We are talking about the changing job patterns here, and we have got to understand this because it is not just China. It is Malaysia, it is the service industry in Bangalore, in India, and you have got to help us understand what this means, because we must then represent this to our constituents back in our home States. So, the question is, what is happening, and is it a serious issue? Is it something which is out of control, or is it something which is inevitable and will right itself? Also, another question is, what can we do together?

I have always felt that you are the engine of our job creation, but, at the same time, we must work very closely together. We have talked about research and development tax credits and investment tax credits and productivity and education and things like that. What are really the serious things that are necessary in order to make us aware of what this changing job picture is? Very, very important for us, so maybe if any of you would like to take that question.

Mr. MALPASS. Mr. Houghton, I will take a crack and then defer to my colleagues here. I think it is clearly a serious issue, especially as you think about individuals within the country. In some cases, they are being overwhelmed by the pace of change going on. That goes to people who have lost their jobs from manufacturing or from other parts of the economy. So, clearly, it is serious and it is affecting a lot of people in the country.

From the standpoint of the good of the country as a whole, I think we are moving forward at a faster rate now in 2003 and into 2004, and so that is good news.

We do have engines of change going on in the economy, so the way I think for you to think about it is to put it into the context of the rapid change going on within both the U.S. economy and the world. The way people are producing goods and services is changing almost daily, and that sometimes is a staggering challenge. My own view is that the United States is in a good position to deal with change. We are an economy based on small businesses, on freedom of the marketplace, and that is going to be the best engines for us.

Mr. HOUGHTON. Could I just interrupt a minute? So, what you are saying is, generally, we are in pretty good control. We are in the midst of a changing sea, everybody is. We are—and being the largest economy in the world, we are pretty well-situated and things like that; is that right?

Mr. MALPASS. Yes, sir.

Mr. PORTMAN. Anybody else have any comments?

Mr. O'HAGAN. I would also like to ask the question, would you rather be in China or the United States, and where do you feel you have the advantage?

I think we have the advantages. There is a natural migration of jobs for types of products, commodities products, that has been going on for many years, but we are moving up the ladder, as it were, to the higher products and services which substitute or take over the lost jobs in the lower end of the ladder, so I think, on balance, we are in very good shape. We have a trade surplus with Korea now. The factory you mentioned has industrial automation.

Mr. HOUGHTON. Would you mind if I just interrupt a minute?

Mr. O'HAGAN. Yes.

Mr. HOUGHTON. I guess we are going to run out of time. I know what you are saying, and I think I feel it, but it is an intellectual response, and that is all you have to give, all we have to give now. It doesn't help the person who runs a small business and is absolutely, totally out-priced by not only China, but also people who have the lower labor rates or whatever have you. It is very disturbing to us, because we have gotten at this through section 203 or section 301 or dumping, but it is beyond that now. There is an entirely different economic picture out there.

The question I have is, are we really as well situated as we ought to be? What are our strong points to be able so that, together, we can build them and combat something which looks on paper something which is runaway?

Mr. JARRETT. Let me mention something. One of the things that has always been strong about the United States has been the, in my area, the high-tech startups that have continually produced great ideas in high technology that America has benefited from. One of the things about a startup is it is not really in a position to offer big salaries, so what they do offer is a piece of the action.

Mr. JARRETT. They offer stock options to their people, and that has been a very important thing in promoting a sense of ownership among these small companies, and now we are seeing the Financial Accounting Standards Board moving in the direction of expensing stock options. All the surveys indicate that the number of stock options being granted by companies will go down as a result of that. We think this is the wrong direction to go in. The stock options should not be—become something that small companies really can't offer or really large companies for that matter.

So, the interesting thing is just as we are moving away from stock options, China is moving toward them. It is in the 10th 5-year plan of China to encourage the use of stock options. So, it is a very unusual situation we are looking at.

Mr. O'HAGAN. I would just offer you one quick example from our industry, and that is medical technology. We are leaders in medical technology. Our exports in medical technology are growing very rapidly, and it is interesting that Phillips Electronics, a Dutch company, has its worldwide medical technology facilities here in the United States.

Mr. HOUGHTON. Well, my time has run out. Thank you, Mr. Chairman. Thank you very much.

Mr. PORTMAN. Thank you, Mr. Houghton. The gentleman from Georgia, Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Sometimes the reason we move away from policy, it is different opinions from people out in the real world, is it affects our Treasury. We don't have as much money to spend. It is not that we tax too little. We just spend too much in this town.

It has been mentioned that we have to have trade. Trade is important. I don't know of a constituent in the 8th district of Georgia who has any objections to producing a product or a service and selling it where it may be in the world. It is their job that they are interested in, whether it be domestic or it be trade, just so as that product or service is delivered.

We have talked a lot about the operation of business and we have no way of setting the standards of operation in any other nation but this one, but we do have—and we go in—enter into agreements with WTO or whether it be bilateral agreements or free trade agreements, and if we enter into one and we sign and we accept, then we accept the consequences of the same. When there are violations by our trading partners, that is when we have to step up to the plate. There are accusations that China is manipulating its currency, dumping whatever it may be, but there is one area that the USTR maybe brought up yesterday that I wonder if you all have had any experience in, and that is China imposing or reducing—giving credit for a VAT for production with the country, which means it costs us more to go in because they could then subsidize through that reduction. Have you all experienced that? I know you mentioned it some in the area of agriculture.

Mr. JARRETT. Yes. In has been a problem in the chip business and semiconductors. As I mentioned, if you design and manufacture a chip in China, you can get 14 percent rebate on that 17-percent VAT, which gives you a huge cost advantage over someone importing chips in and paying a 17-percent VAT. So, this is something that we are concerned about and we are working with the USTR around trying to work with the Chinese government as well to see if it—we can make some changes there.

Mr. COLLINS. Well, in your opinion, is that a violation of trade?

Mr. JARRETT. It certainly—yes. We think that is a violation of Article III of GATT.

Mr. COLLINS. Okay. It was mentioned that we impose—there is a lot of nonproductive costs in production here of manufacturing. What are some of those nonproductive costs? Anyone?

Mr. O'HAGAN. The ones I mentioned in my statement, the legal costs that we have to incur, the health care costs, the regulatory costs, whether it is relating to workplace safety or the environment. Many of these are necessary and they are good, but they add costs to production in this country, and it is part of what puts us at a competitive disadvantage.

Mr. COLLINS. How do those costs or nonproductive costs compare 20 years ago toward percentage of production? Do you have any idea?

Mr. O'HAGAN. I don't have a number, but I would suspect that they are higher.

Mr. COLLINS. As a ratio they would be higher in your estimate I would say so too. We appreciate the fact that you would take time to come here and address the Committee with your concerns. We are all concerned because of our workforce. We are concerned about not being competitive with other nations and their workforce. There are a number of us who believe that there are things that we can do as a Congress that would help our workforce, and we are working through those. Some of it deals with tort reform, medical malpractice, the class action. Some of it deals with the cost of taxation, because we have no border correction provision for you.

Some of it deals with regulatory costs. Very little we are doing deals with regulatory costs. Normally we add two regulatory costs, as we did with the passage of this Sarbanes-Oxley Act of 2002 (P.L. 107–204). Thank you again for being here. Thank you, Mr. Chairman.

Mr. PORTMAN. Thank you, Mr. Collins. The gentleman from Missouri, Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman. I must respond to my good friend from Ohio with her—I am sorry? Each of you are friends, Mr. Chairman, but the outspoken, aggressive tone that Ms. Tubbs Jones took this morning. I, too, am an attorney who actually favors litigation reform. An example would be with asbestos litigation which is a hot topic here on Capitol Hill. There is no question that there are legitimate cases. There is also no question that there have been historically illegitimate cases filed in court with regard to as litigation, and there are cases that have no merit and then there is no penalty for filing a frivolous lawsuit.

I agree with Ms. Tubbs Jones that workers—there are additional protections that have occurred, workplace rules. We have eliminated sweat shops in this country at the same time. As some of you have alluded to, Mr. O'Hagan, in this question of Mr. Collins, China has no Environmental Protection Agency (EPA). China has no Occupational Safety and Health Administration (OSHA). China doesn't have to worry about Internal Revenue Service compliance or health care costs, and each of these things, as we have decided as a society, is a cost of doing business in our country.

I would say as a final comment on this issue, one of those areas is the way that we tax our U.S.-based companies that do business elsewhere. We as a Committee earlier this week had the opportunity to level the playing field, and I wish the bill that the full House would consider—I wish it had received more bipartisan support instead of coming out of this Committee on a party line vote.

That having been said, I do—and I think, Mr. Kruse, your point, regardless of where the level of middle income—or middle class in China, I think the point that you were trying to impress upon us was that the middle class in China is growing, is it not?

Mr. KRUSE. It is growing at a very rapid rate, and I don't think you can relate the definition of middle class in one country to another. It is, again, the ability of people in a certain country to have the ability to purchase goods and services that they choose. It is—China is just an unbelievably growth country in terms of people that have already and will achieve middle class.

Mr. HULSHOF. I appreciate—I know it was a parenthetical, a side during your testimony when you were talking about SPS guidelines, but I appreciate whoever happens to tune into this, that you mentioned the European Union as far as trying to keep out our agricultural products as China seems to do as well.

I do want to ask some maybe tougher questions, however. Mr. DeVos and Mr. Malpass, maybe both to you, because moving down the line, Mr. Jarrett talked about the fact that chips are subjected to—chips from the United States going into China are subbed to VAT that domestically produced, Chinese-produced chips are not.

Electrical products, as Mr. O'Hagan has said, also subject to disparate treatment. We have talked about the agricultural products, and the same thing with piracy. Each of you in your testimony or written statements, though, are cautioning us against—as one of you pointed out—ill-conceived tariffs. Where is the line, Mr. DeVos, as far as trying to—or Mr. Malpass either—as far as making sure that we are given back the Holy Grail, that level playing field that everybody wants but has different definitions for as far as using countervailing duties or whatever we can do when our products have been wronged. As Mr. Jarrett has suggested, for instance, even a violation of GATT, how would you propose that we deal with those types of situations?

Mr. DEVOS. Well, it is certainly a difficult question, and the issue is you have some forums and some provisions to for up. Even if there are GATT violations, there are remedy provisions that are there. In WTO, there are ways to bring people into compliance with areas when they are out of compliance. When there are laws or when there are rules in a rules-based trading system that are in place, the key is to make sure we are—and we have talked earlier a little bit about the Department of Commerce and the Department of State and the USTR, that we are bringing everyone to the table to go through those rules and make sure that they are implemented fairly and properly. I think those become the forums, and once we get out and we start to pick a specific topic or an issue to put on a tariff or to put something, it will have unintended consequences on other areas when things start to get retaliatory. That is what I was trying to articulate.

Mr. HULSHOF. Mr. Malpass, let me ask just a quick question, because my time—and part of this discussion everyone has talked about, and the panel also coming up is also going to talk about currency. You mentioned in your written testimony that as part of a healthy growth policy—on the bottom of page 1—is that we should encourage currency stability, but go on to talk about not trying to pick currency or push the Chinese regarding currency.

So, do I hear you to say that we should maintain a rigid strong dollar policy in this country and yet allow China to continue to undervalue their currency?

Mr. MALPASS. I think the best for both countries is to have their currencies be relatively stable over long periods of time. That then allows investment, and it allows the economy to concentrate on what it can do best. One of the problems that we have had in recent years is the volatility of currencies. We saw the negative effect of that in the late 1990s when the dollar appreciated substantially and disrupted the economy. We have also seen the effects on the other side when countries let their currencies go weak. Mexico, for example, has continued to see its living standards stagnant because of the periodic weakness of their currency.

So, my opinion—and it is different from some other economists—is that countries grow fastest when they have stability within their exchange rates. That is what allows businesses to do their jobs and workers to do their jobs rather than worrying about where the currency is going to be.

Mr. HULSHOF. Thank you. Thank you, Mr. Chairman.

Mr. PORTMAN. Thank you, Mr. Hulshof. The gentleman from Wisconsin, Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. I am very glad we are doing this hearing over the 2 days. This is an issue that really affects many of us. I come from Wisconsin which has more jobs per capita tied to manufacturing than any other State in the country, so this is an issue that we really want to focus on.

I wanted to talk to you for a second, Mr. Malpass, and ask you on the VAT shifting issue, where we see that our tax code is out of sync with our competitors, particularly China, where they are taking their VAT and shifting it on to ours essentially by lifting it on their exports and putting it on their imports. We seem to have a tax system that is directly out of sync with that, where we tax our exports, don't tax our imports and we overtax our manufacturers.

What do you think we can do to change our tax code to make it more in sync with our trading competitors so that we are on a more level playing field and that they don't have this incredible advantage that they are taking over us?

Also I would like to point out, Mr. Jarrett, that the concept and the idea that it is GATT illegal is one that is in great dispute. Many countries believe that because the VAT is an indirect tax, that that is GATT illegal. If they are picking and choosing certain sectors to adjust that, that is illegal; but the general concept of having a VAT that is border-adjusted, which is an indirect tax, is considered to be GATT legal.

The way we did it with a direct tax and an export subsidy with our FSC benefits was determined illegal. We can debate that, but the point is the WTO has ruled four times on that point. So, what I would like to ask the two of you, do you think we should do to make our tax code more helpful with respect to putting our exporters on an equal playing field and taking some pressure off of our manufacturers who are clearly being overtaxed?

We will start with Mr. Malpass, and then how about Mr. Jarrett, and if anybody else has any opinions.

Mr. MALPASS. Mr. Ryan, thank you for the question, but it is a very hard question. This Committee has really studied that issue of how to deal with a border-adjusted VAT when we don't have that system.

One of the things I would observe is that a VAT has many negatives. It is for one not progressive—in other words, people are paying tax on what they consume, and so it hits the poor more than the higher up.

I am simply not in favor of a VAT. You have to look at other ways that the United States, as a free country, can have an effective and efficient tax system. My small answer to your question is simply to have a tax reform that lowers the rates and is not quite so complicated as our current system.

The goal is to allow U.S. businesses to be competitive internationally. The best way to do that is just to have a better tax code than the one that we have now, and that means a lot of work by your Committee. I think that the bill that you are putting forward to replace FSC looks to me like a movement in the right direction.

It won't solve this constant complaint that countries with VATs get to rebate them when the exports go out, but I think you should also recognize the huge negatives that a VAT causes those countries.

Mr. RYAN. Can you not border-adjust a tax system that is not necessarily a VAT putting the WTO rules aside?

Mr. MALPASS. That is a question that I can't answer.

Mr. RYAN. Mr. Jarrett.

Mr. JARRETT. I think I would echo Mr. Malpass' comments. I think you are already looking at two key things from our standpoint. One is to come up with a successor to FSC that gets us back to some of—some level of the benefits that we have under that now illegal mechanism; and second, to look at a better way to tax the foreign income of companies like Intel so that there isn't the burden that we have now.

I guess the third thing I would add, which would be a temporary stimulus and was really suggested first when it—as a stimulus measure when we were trying to come out of the recession, would be the Homeland Investment Act (H.R. 767) to bring back an estimated $300 billion that is now outside the United States.

Mr. RYAN. One more—if I may, if the Chair will indulge me, for Mr. O'Hagan. I was interested in your testimony where you said that some of your members face competition from Chinese goods that appear to be subsidized based upon the very low seller price that you observed.

How difficult is it to identify the subsidies in China, and how can you or the Federal Government investigate these alleged subsidies? How easy or difficult is it to peel away the layers of the onion to identify those government subsidies, that industrial planning that they are engaging in?

Mr. O'HAGAN. It is very difficult with our financial system in the state it is in, and I don't have a good answer. We know that it is there, and these things are always hard to investigate, whether it is in China or any other country that has subsidies.

In fact, the foreigners will also contend that we have subsidies here in different forms. So, these are always very difficult and contentious and hard to get to the core of.

One other general comment is we are in the era of globalization. It is a transition area. We represent one of the great companies, we represent Rockwell from your State. They are a world leader in industrial automation and doing extremely well and have positioned themselves very well locally to tap into what is happening on a global scale, not just here in the United States.

Mr. RYAN. Thank you. Mr. DeVos, did you have a comment you wanted to add?

Mr. DEVOS. No.

Mr. RYAN. Thank you, Mr. Chairman.

Mr. PORTMAN. Thank you, Mr. Ryan. The gentleman from Illinois, Mr. Weller.

Mr. WELLER. Well, thank you, Mr. Chairman, and, again, I want to thank Chairman Thomas for the leadership in conducting this hearing and thank our panelists for being here today and participating in today's hearing. There is a couple of directions I would like to take in my questioning, and the first obviously is—builds on what my friend Chairman Crane made reference to with the economic news that we heard yesterday of the 7.2 percent economic growth, and Mr. Malpass, I am sure the economists on the panel. There has always been debate when we put together the jobs and economic growth package that the President signed into law in May.

There were arguments in the House over whether it is a good idea to lower taxes, particularly for business and small business and individuals who happen to be investors. In talking with various sectors of the economy over the last month and determining what is the impact of the jobs and economic growth package that is signed into law in May, the electronic sector has indicated they have seen about a 38-percent increase in demand for their products. The aviation manufacturers have indicated about a 44-percent increase in demand for their products. They credit the bonus depreciation component of the jobs and economic growth package.

At the same time, we are seeing what appears to be clear evidence that the jobs and economic growth package is working. There are some here in the Congress and others outside the Congress who advocate a repeal of the jobs and economic growth package, and as an economist, Mr. Malpass, what would be the economic impact of repealing the tax cuts that the President signed into law as part of the jobs and economic growth package?

Mr. MALPASS. Yes, Mr. Weller. I think that that should be analyzed as a tax increase, and we know from experience that when taxes go up, the activity that is being taxed goes down. In this case what the jobs and growth package did was to lower the tax rate on labor through the withholding tables, and also on capital. We got more of that. We saw that in the third quarter GDP number, more economic activity.

One of the things that I think the tax cut hasn't been given enough credit for is simply the stock market gains, which affect a lot of Americans nowadays. The market capitalization rose in just the second quarter by $1.7 trillion. I think that was a partial result of the tax cut, in that it was cutting the cost of capital and raising the value of equity.

So, I would expect several effects if that tax cut were repealed. You would see less labor because labor was advantaged by the tax cut. You would see less capital, and you would see a lower stock market, simply the reverse of what happened in the second and third quarter as a result of the tax cut.

Mr. WELLER. Well, one thing that these industries have shared with me is they always point out that when someone has an incentive to buy a bulldozer or a company car or a machine tool or replace their telecommunications equipment, there is a worker somewhere in America who has been working to produce that product. So, it creates jobs. We are starting to see those positive job numbers as well with that for the first time in a long time, new jobs being created as a result of the jobs and economic growth package.

Mr. MALPASS. I do think that we will see more of that going forward. One of the good pieces of news in yesterday's GDP report was the big rise in business equipment spending. We are right now still in this anomaly of having businesses drawdown their inventories. What I think is going to happen in the fourth quarter is businesses are going to look at the growth and say we need more inventory, and that is going to put a lot of people back to work.

Mr. WELLER. Well, we certainly hope that is the case. The evidence indicates that is what is happening.

Shifting to the issue of IPRs, and Mr. Papovich, Mr. O'Hagan, you focused on the issue of IPRs. As one who is a free trader and who believes that one of the most important understandings we need to have with our trading partners is the protection of property rights, particularly from those who create, that they should be rewarded for their creativity and their IPRs should be protected.

There are many concerns that have been raised regarding the Chinese and whether or not they are honoring their commitment as part of the WTO regarding IPRs. Mr. Papovich, Mr. O'Hagan, you both focused on that in your testimony. It is in the—and I would like to hear a little more greater detail from you on what your perspective is; but China's criminal law established thresholds for initiating criminal prosecutions for copyright and intellectual piracy, and many as Mr. Papovich and others have noted, suggest and believe that those thresholds are impossible to meet, which means that there has been very few prosecutions of those who are involved in their own industry of piracy.

I was just wondering, have you seen any evidence that the Chinese Government is working to honor that commitment, any evidence that they are taking steps to address what is clearly a serious problem that affects our relationship with their country? Mr. Papovich.

Mr. PAPOVICH. First, certain levels of the Chinese have been very aggressive. As I said—last year, in 2002, they conducted 20,000 raids of people selling in the marketplace—market operations, retail level raids, and seized 75 million CDs. So, at that level we have progress. We have action at least.

We had an unfortunate interpretation by the Chinese supreme court a year or so ago that created this problem with getting criminal prosecutions, where they ruled that evidence seized didn't count, there had to be records of actual sales of pirated products. That needs to be changed.

We are working—and I must say the U.S. executive branch is working very hard with us—to get a new interpretation issued. It is extremely important.

Now, it could come to the point where we conclude that the Chinese just aren't going to change this interpretation. It is possible. If that were to happen, then we would need to consider a WTO action, and we think we would have a good case. That, in and of itself, would take a while to play itself through, and even then if the Chinese didn't change, sanctions wouldn't affect us, maybe somebody else's exports in some other industry in the United States wouldn't receive imports because the United States would impose sanctions.

So, that is not the optimum solution. The optimum solution is getting this interpretation changed. At the moment, as I have said, and you have just repeated, we are not able to get criminal prosecutions, and for the pirates in China, the sanctions that are currently imposed—the fines are seen as just a cost of doing business.

Mr. WELLER. Mr. O'Hagan.

Mr. O'HAGAN. We have seen a serious counterfeiting problem with dry cell batteries that are hurting companies like Energizer and Duracell and Rayovac. We have seen it with the wiring devices. All I would say is whatever the Chinese are doing to address the problem is obviously not adequate at this point.

One thing in time that will happen is that the legitimate Chinese manufacturers themselves will start to share our concern, because their business is going to be undermined by the pirates. So, hopefully they will put additional pressure on the Chinese Government to take the proper action to close down these pirate operations.

Mr. WELLER. Mr. O'Hagan, let me ask you——

Mr. PORTMAN. Mr. Weller, can we make it short? We are over time and Mr. English is waiting to question.

Mr. WELLER. May I just have a quick follow-up? Mr. Papovich, I know you indicated the executive branch, the Administration has been engaged on this issue. Mr. Papovich and Mr. O'Hagan, do you feel you are getting the support you need from the Administration from the Department of Commerce, from the special trade representative to pursue real enforcement of this commitment on IPR? Mr. O'Hagan.

Mr. O'HAGAN. Yes, I think. So, we are bringing it to their attention. We are trying to quantify the nature of the problem to help them, but they are certainly receptive and understand what the problem is and are trying to address it in the best way as they can.

Mr. WELLER. Mr. Papovich.

Mr. PAPOVICH. Yes. We do feel that we are getting good help at this time.

Mr. WELLER. Thank you. Thank you, Mr. Chairman.

Mr. PORTMAN. Thank you. The gentleman from Pennsylvania, Mr. English.

Mr. ENGLISH. I wanted to thank the gentleman, and as I have listened to the panel, it has provided certainly a range of very interesting insights. I think for the most part, supporting positions that each of us have already come into this hearing with, but also some additional new insights.

Mr. Jarrett, I want to congratulate you on making the link between trade policy and tax policy and suggesting some new incentives for capital investment that I think are necessary to allow American manufacturers to continue to thrive in the context of an increasingly difficult international marketplace and do it on the basis of comparative advantage.

Mr. Kruse, I want to thank you for bringing up one of the forgotten sectors of this debate on China, and that is Chinese consumers who I think are being beggared by China's currency regime and put at a large advantage in their buying power significantly reduced.

Mr. DeVos, you have offered some very interesting testimony to the effect that we need to adhere strictly to our WTO obligations, even though that statement seems like a moving goal post; and yet, the Chinese should not have to adhere to their WTO obligations.

I have to say that I think the Chinese need to have a currency regime that reflects the real value of their currency. I believe in response to Mr. Hulshof's question, you said that we should use WTO mechanisms in order to enforce China following its WTO obligations. In your testimony, you acknowledge there is no WTO mechanism for enforcing the WTO standard on currency, which I believe China has clearly violated.

That is why I have introduced the China bill, which does provide in lieu of any other opportunities to pressure China. The option of tariffs in proportion to the distortion involved. Those are contingent tariffs. I know most advocates of free and open rules-based trade are reluctant to see tariff proposals floated out there, but as a practical matter, at the end of the day, if the Administration's negotiations with the Chinese are unsuccessful, I see very little alternative and very little recourse, and I hope we can all agree around here to distinguish between using tariffs as a sanction of last resort as opposed to tariffs as a standard policy. That brings us to your testimony, Mr. Malpass, which I thought again was interesting.

You have spoken out against the idea of China floating its currency, suggesting that that was unnecessary, although most of the evidence suggests that there is a serious distortion here even if it is a long standing policy of distortion. You also make the point that there will be no net increase in jobs in your view if the Chinese change their currency policy, which to me is a chimera, because the real issue here is whether we are losing jobs because of Chinese currency policy and other factors, that we would not otherwise be losing based on comparative advantage.

So, Mr. Malpass, could you explain in greater detail why you believe the weaker dollar relative to its strength in the late 1990s would not make some marginal improvements at least in stemming the outflow of manufacturing jobs and manufacturing capacity that we would not otherwise lose, and would not exports increase and exporting firms' employment grow minus adjustments for increases in productivity?

Mr. MALPASS. Mr. English, I think economics is of several views on the issue of the connection between a change in the exchange rate and the effect on employment and jobs.

Mr. ENGLISH. My time is short, so I need a one-handed economist.

Mr. MALPASS. I think history shows us that when a country has a weak currency, it doesn't see its exports go up. What it sees sometimes is itself fall into a recession and its imports go down because its living standard has fallen. I don't think that is really what we want for the United States.

If we move into a weak dollar policy, what I think we would see is capital exit the United States, our economy would weaken, and it really wouldn't be good for our consumers or people in any way.

Mr. ENGLISH. I thank you and I am out of time, but, Mr. Chairman, I certainly hope, based on this testimony, that none of us embrace the notion that the solution to Chinese state-sponsored mercantilism is to adopt in the economics sphere the prescriptions of the nuclear freeze movement. I yield back the balance of my time.

Mr. PORTMAN. I thank the gentleman from Pennsylvania and I think he has raised some interesting points. I am going to take my time now for questions, and then Ms. Tubbs Jones has some follow-up questions.

First following on, Mr. Malpass, to keep you on the spot here with regard to Mr. English's question. In response to concerns raised about currency manipulation, you made the statement earlier that actually the Chinese practice encourages investment and its stability in currency is good for investment.

On the second panel, we will have more opportunity I think to get into the currency issue of some U.S. manufacturers who have been directly acted. Is that fair investment? In other words if the Chinese currency is not allowed to flow and if, in effect, the U.S. investor therefore can invest with 75 cents or even 65 cents on the dollar in China and make investments there in terms of jobs, plant and new equipment, rather than here, is that investment we want to encourage?

Mr. MALPASS. China has kept its currency relatively stable against the dollar since the middle 1993. In 1997 when there was the Asia crisis, it was characterized by devaluations by other countries in Asia but not by China. Those devaluations, for example, in Indonesia, Korea, Taiwan, hurt the U.S. economy. In fact, on a National Income and Products Accounts basis, U.S. corporate profits peaked in 1997 and then fell thereafter for many years as we fell into the deflation cycle. China has stuck with its current policy for 10 years now.

How does that encourage investment in China? When a business looks at a foreign country, one of the risks that it doesn't want to take is that the exchange rate is going to move. One of the big problems Mexico has had is that their currencies are volatile. When the investor thinks about building something in that country, the currency risk becomes insurmountable. Look for example, at Malaysia which has kept its currency pegged against the dollar. It is very attractive spot for electronics investments, because they don't have to worry about the currency moving.

In my view, it is fair and proper for a foreign country and for the United States to want to keep its currency relatively stable as a platform for investment.

I think one thing that we could look at is for other countries, say Mexico, Dominican Republic, countries in South America and in Africa, to keep their currencies more stable. I think that would help their growth rate.

Rather than trying to push China to be like a poor, moving-backward developing country, it might be useful to see other countries try to keep their currencies more stable and move forward faster.

Mr. PORTMAN. I appreciate that, and yet I do think it would be helpful if you could more precisely address the issue of when our currency is relatively low, as it is now as compared to the late 1990s, is it fair for a country like China or Japan for that matter not to allow the currency to fluctuate so that at a time when U.S. manufacturers are under stress and when we are competing legitimately on wages, there is an additional advantage to U.S. dollars going to those countries, particularly China, to establish what will be longer term manufacturing jobs because of that manipulation? I guess your answer would be in part, well they did it both ways. They allowed it to peg when it was high and now when it is low, and so it is fair. I just wonder if that is a legitimate answer to a pressing concern we have here in this country, given the state of manufacturing and the fact that these are not just short-term decisions when you make those investment decisions.

Mr. MALPASS. One other point that I will make then, and it was in my statement, is that if we went into a period where China's currency were viewed to appreciate, that becomes very attractive for new investment. Japan saw that in the 1980s. So, as the yen appreciated, the pace of new investment——

Mr. PORTMAN. I noted that in your testimony and that was interesting, because it would seem counter to sort of a natural inclination to be able to find the place where your dollar can get the most bang for the buck, but you attribute that to the fact that showed a strengthening economy and more stability and a better business climate perhaps.

Mr. MALPASS. Yes. I think a lot of the economic theories in this area were developed in the 1950s and 1960s when we were on the gold standard and haven't really been updated for the floating exchange rate world that we are in. The reality is that capital flows are outweighing the trade flows. The economic theories were based on the opposite view and haven't really been updated. So, what we have seen in practice is that Japan in the 1980s, as it appreciated its currency, attracted investment. The same happened to the United States in the 1990s. As the dollar appreciated, it attracted investment to the United States. It is the reverse of many of the economic theories.

I think we should be cautious in encouraging China in that direction, because I think in their case also they would see even more investment—we would see more job losses. They would see more investment in China from an appreciating currency.

Mr. PORTMAN. Well, thank you. We will get into this more in the next panel. Are we talking about investing in currency in the dollar, or in plant equipment again and things that can hurt our U.S. workers.

If I could just briefly ask all the panelists to very briefly respond to a question. I thought Mr. Kruse's comment earlier perhaps was the best summary of where we are. China presents, you said, an opportunity and a threat, and I think you mean to U.S. workers. I think you are right.

In terms of addressing that threat and addressing the challenge, we have gone through a number of issues as I have taken notes. One is the currency manipulation issue. Another is piracy and intellectual property violations, how the VAT is imposed. In China, a 17-percent VAT is imposed, and those are taxes imposed on our exports and not on their imports to the United States.

I am told that as of January 1, they are going to change that policy somewhat, but that is obviously a distortion of the trade adjustment. We have talked about other WTO obligations including government subsidies. Mr. O'Hagan talked about that, and then finally U.S. policies that affect jobs here.

If you could just give me one thing that addresses this threat or challenge from China that we should be doing differently as a country, either in terms of our U.S. policy or in terms of our international policy in particular with the USTR, the Department of Commerce and the Department of the Treasury, what would it be? Mr. DeVos.

Mr. DEVOS. Well, the first thing I would say is to not just get distracted on very specific or smaller parts of the whole relationship. This is a long-term relationship. We need to develop global trading partners. We need to develop them in a way that is consistent, that is defined, that can be monitored and developed over time; and, therefore, sometimes we have other trends that come in that can get us distracted. So, I think our key issue is to not be distracted.

Now, I say that in an understanding that those distractions impact people's lives, and we care about that. We understand that. So, therefore, we have to view our long-term policy very sensitively in that respect.

Mr. PORTMAN. Long term. Mr. Malpass.

Mr. MALPASS. I would sing that old song—accentuate the positive and eliminate the negative. The United States has a lot of strengths. Build on those strengths. That means strengths of small businesses. Lower the tax rates more, and educate more. Then eliminate the negative. Try not to have harmful regulatory policies, litigation policies and so on down the line.

Mr. PORTMAN. Mr. Jarrett.

Mr. JARRETT. I think recognize that the world has changed. This isn't just a China issue. If you look at China, India, Russia, Malaysia, Vietnam, many countries are now participants in the world economy, and they weren't 20 years ago. The world has become a much more competitive place. We need to make sure that America's policies promote our own competitiveness against this more—in this more competitive world.

Mr. PORTMAN. Thank you. Mr. O'Hagan.

Mr. O'HAGAN. Curtail regulatory costs, more favorable tax on manufacturers and absolute enforcement of the rules of the game through the WTO.

Mr. PORTMAN. Thank you. Mr. Kruse.

Mr. KRUSE. I think on the one hand, we have to continue to be firm and to make China understand that we expect them to play by the rules. At the same time, as has been mentioned by others, we have to have the discipline to have the patience to understand that any time you are dealing with a country that is a non-market economy that is trying to evolve to where we have already come, it does create some problems, and finally very quickly, Mr. Chairman, I would say we knew—we all knew there were going to be problems when China came into the WTO, and certainly there are. We are far better off to have them as a part of the WTO and have certain rules they have to play by than to not have them.

Mr. PORTMAN. Thank you. Mr. Papovich.

Mr. PAPOVICH. Consistent with what several people have said, I would say that with the Chinese we have to be precise as to what we want, and we have to keep pressing. I think some in China count on the fact that we will get distracted and go off with some other issue, and so we have to keep—we don't become distracted, keep pressing and be precise.

Mr. PORTMAN. Good point. Ms. Tubbs Jones now has some follow-up questions.

Ms. TUBBS JONES. Thank you, Mr. Chairman. Gentlemen, I accept my colleagues' characterization of my questions as aggressive as a compliment. The people of the 11th Congressional District expect me to be aggressive, and I know you don't expect any less from your Congressional Representative. Lest you think that I am not supportive of exports for companies and I am not pro business, I want you to know that I did support the Democratic substitute that offered some tax savings for businesses, and that was paid for.

I also want you to know that on November 10, I am a speaker at a luncheon, because I put together a program in my Congressional District for businesses to get engaged in exports through the Department of Commerce. I am so pleased to let you know that Bechtel Steel in my Congressional District is receiving an award for its aggressive activity in trying to do export business.

Finally, I would ask you, Mr. O'Hagan, to talk to Rockwell Automotive. I have been to visit with them. I have been to visit with one of their subsidiaries. I am one of the people they do business with. Central Brass is catching hell because it is one of those little small businesses that has a niche that China is competing with. I have been to Goodyear Tire, and Goodyear is the last remaining American tire maker in the country, and they are screaming at me, help me, help me, help me. I have also visited Olympic Steel.

My last question to each of you is—and any of you can choose to respond to it—in the statements yesterday, there was a real discussion about China taking over some of the business that Japan had done, and Japan folks are moving into China to do business and other countries. What is the risk of us having so great a dependency on China that other countries are moving in to China and then China says to hell with you all, we are going to do what we want to do and we don't—the use of the WTO, to my opinion so far, has not really put them in check for the violations that they are involved in? What is the risk there? How do we address that risk with a heavy reliance on China in operating and in our investment and so forth?

If the question isn't clear, Mr. Jarrett or—I can see a question on your face. Whoever. I would appreciate a short response, and I thank the Chairman for giving me the opportunity.

Mr. O'HAGAN. One very quick response is that if the Koreans and Japanese and others are going into China, we would better be there, and that is imperative that we are ahead of the curve so we can compete with them, and we are the ones getting the advantage. I don't see that there is a great threat or concern.

Mr. DEVOS. I would just answer as well, it is always hard to assess risk, but I think the comment made that having them part of WTO, as imperfect as it may be, or however many challenges we may have at this time, having them part in the whole idea of global trade—we have mentioned many other countries here in even this hearing that reliance on one country, I think, that risk decreases every day as more and more economies begin to engage in trade and as we begin to have an organization that tries to develop trade.

Ms. TUBBS JONES. Thank you very much. I appreciate your responses, and thank you for appearing.

Mr. PORTMAN. Thank you, Ms. Tubbs Jones. Are there additional follow-up questions for members of the panel? Mr. English.

Mr. ENGLISH. Yes. Briefly. Mr. O'Hagan, you cite technical grounds for some of the trouble your members have getting their products into China. Is this, in large part, due to the fact that your members must meet the quality standards of the United States and then once again—and then once they decide to export to China, have to go through an entirely different and sometimes altogether nontransparent standards process for the Chinese? To what degree do you think these dual standards processes place American products at a competitive disadvantage in China?

Mr. O'HAGAN. Mr. English, the nature of the products we make requires that they be tested and certified for safety, and the most common mark in this country is the UL mark, in Canada, the CSA mark. In Canada there is a China Compulsory Certification (CCC) mark, and if a company gets its products certified here, when it goes to China, it has to go through an additional cost of getting the CCC mark, which we really think is unnecessary. The mark that is issued in this country is absolutely legitimate and should meet their needs.

So, the requirement for the CCC mark not only does it add cost, but more importantly it delays the acceptance of their product in the marketplace.

One of the reasons we are opening an office in China is to help to address that issue with the officials in China.

Mr. ENGLISH. You also mentioned that your members are faced with the difficulty of competing against, as you put it, "potentially subsidized products coming into the United States." I am curious if you put subsidized in quotations in your testimony, because under current U.S. trade law, there is no way for your members to bring a countervailing duty case against Chinese electrical product producers because of a court decision a number of years ago that held that we can't apply countervailing duties against a nonmarket economy. Your comment.

Mr. O'HAGAN. Well, that's obviously a limitation. In my comments, I didn't intend to imply that that is our most serious problem. In fact, I think a more immediate and serious problem we face is the counterfeiting issue that I addressed.

[Additional information follows:]

We would also like to take this opportunity to follow on the question posed by Representative English regarding our description of some Chinese products coming into this country as "subsidized". With some NEMA members reporting imports into this country being priced lower than the costs of inputs, we certainly sense that something illegal is being done (be it, for example, subsidies from various levels of government, or overly generous loans courtesy of China's shaky financial system), but at this time it is hard to know exactly what or how it should be formally defined.

Mr. ENGLISH. Thank you. Thank you, Mr. Chairman.

Mr. PORTMAN. I thank you, Mr. English. I want to thank the panel again for giving us some very helpful input as we struggle with these issues with the opportunities and challenges we face with China, and we look forward to continuing to work with you and look forward to having you submit any additional comments you may have for the record. Thank you all.

We would now like to call the final panel for this 2-day hearing on the U.S. trade relationship and economic relationship with China. We are pleased to have with us Larry Galbraith, who is President and CEO of Denim North America in Columbus, Georgia. Jeb Head, who is President of the Atkins & Pearce, Incorporated, of Covington, Kentucky. Jeffrey T. Somple, who is President of Mack Molding Co., Northern Division, Arlington, Vermont and Westford, Massachusetts. Finally, Richard Trumka, who is Secretary Treasurer of the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO).

Gentlemen, welcome. We look forward to your testimony. As you saw in the previous panel, we will endeavor to keep the testimony of each of you to 5 minutes. We have an opportunity for exchange with members of the panel. As you know, your full testimony will be made part of the record, and you certainly have the opportunity to submit additional comments for the record if you feel in the dialogue that there is a need for more information to be provided to this panel.

As you saw yesterday, we had interesting testimony from the government side. We had the Department of the Treasury here, the USTR, the Council of Economic Advisers, CBO, GAO, and also the USITC. Then earlier today we have heard from the private sector both through trade associations and through individual companies.

Today we have the opportunity to continue that private sector analysis of our situation with China. I would like to ask my colleague, Mr. Collins, from Georgia, if he would like to introduce our first witness.

Mr. COLLINS. Thank you, Mr. Chairman, and I appreciate the opportunity to do this. I appreciate the Committee in working with me and inviting Mr. Larry Galbraith from Columbus, Georgia as he is President and CEO of Denim North America, which is based in Columbus. He has some 30 years experience in the textile industry. Having that experience and actually had left textiles for a while and went to construction, but back into textiles in 2001 when the Japanese company by the name of Marubeni in Columbus decided that they would sell out, he was part of a team that went in and purchased to keep those jobs going. We appreciate that very much.

He is going to bring to us some first-hand knowledge of what is happening in the marketplace with textiles. He told me he just returned from a 4-week—prior to coming to Washington last night, he had been in Central America, I believe, on some trade business. He has a lot of knowledge and a lot of information, I think, that would be helpful to us in the area of textiles. He also recognizes something else, Mr. Chairman, because when you read the bulletin that he puts out to his employees on a monthly basis, he talks about the other industries in this country that are also suffering from trade—lack of trade or lack of exports from here but the overabundance of imports company. So, he is not just narrowly focused on the textile industry.

Also, Mr. Chairman, I want to have permission to enter into the record a letter from also another manufacturer of textile products from Forsyth, Georgia, a letter that he wrote to the President outlining some of his concerns about the textile and imports. Thank you, and welcome, Mr. Galbraith.

[The information follows:]

Trio Manufacturing Co.
Forsyth, Georgia 31029
June 6, 2003

President George W. Bush
The White House
1600 Pennsylvania Avenue, NW
Washington, DC 20500

Dear Mr. President,

I am writing you today about a matter that is heavy on my heart. I am president of a small textile manufacturing company that was started in 1899 by my great grandfather and two other men. We are in the sales yarn business which means we purchase raw cotton in bales then spin this fiber into yarn that we sell on a cone to the home furnishing, apparel and specialty trade. We presently employ 65 people. Most of our sales are domestic, however, we do have some export sales, and we are attempting to expand this segment of our business.

In 1999 our revenues were $7 million, in 2000 they were $6.3 million, in 2001, $4.6 million, in 2002, $4.7 million, and for this year revenues are trending below $4 million. For the last 2½ to 3 years we have operated at a slight loss or a very small profit. We have accomplished this by being as frugal and cost efficient as possible. There is no fat in our company.

Since 1994 we have modernized our plant and equipment and have reinvested over $3 million. Improved productivity and quality have allowed us to continue to exist. We have just committed to invest another $1.4 million in additional equipment in our plant that will be installed in November and December of this year. We are financing this with a $1.1 million loan from a regional bank.

We are aware that the new tax bill that was just signed will give us a 50% bonus depreciation on this equipment. This will help us in the future, but it does not help us if we can not make a profit. Our associates earn approximately $10.00 to $15.00 per hour so we are not a minimum wage payer. In addition to our wages we pay all but $8.00 per week for the health care coverage for each of these individuals who work for us. Without these jobs these individuals will not have health insurance and if they have a medical need the county taxpayers would assume the cost of any medical attention they receive at our local hospital's emergency room. We have not had a wage increase in our company for anyone, including myself, since September 1999.

In 1990 there were over 2,000 textile jobs in our county with a population of around 20,000 citizens. Today there are less than 200 textile jobs in Monroe County, Georgia. Last year in this country there were 116 textile mills closed that eliminated 67,000 jobs. The U.S. textile industry in April of this year experienced an additional 6,000 jobs that were eliminated.

We are frustrated, mad and scared. In order to compete internationally we must have an extremely modern and efficient plant which produces a quality product, and this costs money. We must make a profit and keep a positive cash flow, provide benefits to our associates and finance the needed equipment to stay modern.

I commend you and your leadership in Washington for the recent legislation that granted the American public tax relief. I have heard you repeatedly say we need to create jobs in America, and this legislation will help. Mr. President, why not put emphasis on keeping the jobs already established in this country? To me this should be our first priority.

I was present at the American Textile Manufacturers Institute (ATMI) annual meeting in Washington in March, 2002, and I heard our Secretary of Commerce, Donald Evans, say "know that you have a friend in us—know that you can trust us." He also stated, "that our President understands the plight of the textile industry." Mr. President, do you really know our plight? We are hurting. We were told we should measure your administration by what you do and not by what you say. Well, the loss of 67,000 jobs in our industry in 2002 certainly is alarming to me and particularly to those individuals and the communities directly impacted.

The entire textile industry is being systematically dismantled. Since I started my career in 1971, I can well recall the powerhouses of our industry. They were Burlington Industries, West Point Stevens and Fieldcrest Cannon just to name a few. I have known the management of most of these companies in my career, and it is simply beyond my comprehension to even think that any of these three companies would ever declare bankruptcy, but that is exactly what has occurred. In fact, West Point has just declared bankruptcy for the second time. Bankruptcy is a black mark on a person's name and reputation. This is the very last thing I would ever consider for our company. If things do not improve I would take the road of paying off all debt and simply closing the doors of our small company. Please help us so this will not happen.

Manufacturing is vitally important to the economy of any country, and manufacturing in this country is on a slippery slope at present. Foreign competition is everywhere and many times it is heavily subsidized by that country's government. Added to this are illegal shipments that circumvent the custom laws of this country. The manipulation of foreign currencies (particularly China) continues to harm U.S manufacturers.

I heavily endorse your stance on terrorism and your decision to free the Iraqi people from the rule of Saddam Hussein—a truly horrible dictator. America is free and strong because of our military superiority, and we can preserve peace only by military strength. In a similar vein, we can preserve our freedom and strength in the world economies by maintaining and supporting a strong and diversified manufacturing base in this country. If we continue to lose this vital economic ingredient we will eventually become a weakened nation, subject to the control of some future super power. Stop building the world! We need to be concerned about America first!

I could list dozens of specific instances where your administration has failed to support the U.S. textile industry, but the one that galls me and other leaders of our industry the most is the recent bilateral trade agreement that was signed with Vietnam—a communist country. Our industry was misled again. When is this going to stop?

You were granted Trade Promotion Authority in December, 2001, much to the dismay of many textile state congress men and women. It appears these representatives were correct if the trade agreements we get now and in the future are similar to Vietnam. Upon approval of TPA you made this statement reference textile workers, "they have a right to expect a trade policy that guarantees that competition for markets will be free, open and fair." You also stated, "I intend to ensure that the interest of our textile industry and workers are at the heart of our trade negotiations." What we need, Mr. President, is "fair trade" and we are not getting it. You have failed us and lied to us.

Take care of America first. I am deeply concerned about the 65 people who work for our company. We are risking the financial security of our company's shareholders and associates by making this capital investment. But if we do not invest in our plant and equipment, we have no hope. So the real question is why should you and your administration be concerned about these 65 people and little Trio Manufacturing Co. and their future? I feel the answer is that companies like ours are being negatively impacted all over America. Important jobs are being eliminated, Mr. President.

Stand up for U.S. manufacturing. Support us and help us. Will you heed this call for help or simply turn a deaf ear to our company and our industry's plea? Time will tell. The future of America's strength and its future generations is now and it is at risk. I am very afraid I see a significantly weakened America in ten, twenty or thirty years. Please, please help Trio, its associates, our industry and all of America.

I am praying for you and our country just as I am praying for our company, our associates and our industry.

Sincerely,

Howell W. Newton
President

STATEMENT OF LARRY L. GALBRAITH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DENIM NORTH AMERICA, COLUMBUS, GEORGIA

Mr. GALBRAITH. Thank you very much, Congressman. I want to commend this Committee for taking time. I think it is important that the discussions that are taking place in this hearing where we look at both sides of what is going on, what is good for China, what is good for the United States. I think what is important and what I am concerned about is the job losses that we are incurring in this country.

When I look at the numbers and I see that we have lost over 2 million manufacturing jobs in this country, it gives me great concern. I am concerned because of those 2 million jobs that were lost. Many of them also lost their health care, and what I want to talk a little bit about this morning is the textile industry and the effect of job loss in this textile industry.

As Congressman Collins said, a group of us bought a denim facility in Columbus, Georgia to preserve at that time 300 jobs. Today we have 240 jobs, because we have been impacted by imports from China.

In Georgia, there are close to 90,000 people employed in the textile and apparel industry. In this country we have 630,000 employees in this industry; yet, each day we pick up the newspaper or we go on the Internet and we see where we have had another plant close.

Today you have many of the major textile industry producers that are in bankruptcy. You have Westpoint Stevens in bankruptcy, Cone in bankruptcy, Burlington in bankruptcy, and Galey & Lord in bankruptcy. This year already other denim producers, Avondale Mills has closed three of their facilities. Cone has closed two of their facilities. Swift has cut their workforce virtually in half, and you have taken about 100 million yards of denim production out of North America.

Let's think back about when we talked about the WTO, the GATT Agreements, the NAFTA Agreements, and if you remember at that time, this industry was told to formalize this with your partners and countries in Mexico, Honduras, Guatemala, and I can tell you we have done that.

As Congressman Collins says, I have just returned from a trip through Mexico, on through Guatemala, into Honduras, and I can tell you as the decline of textile and apparel production in this country happens, the same thing is happening in Mexico.

I was at one of the large cutters that cut and sew jeans. They virtually have the capacity to cut about 600,000 dozen pairs of jeans a week. This past week they cut their workforce in half. That is astonishing. Here you have cheap wages that are not cheap enough. So, not only are we going to be affected by these job losses in this country, our neighbors in this hemisphere are going to be affected by the same thing.

I can tell you that the textile industry has invested heavily to become very competitive to remove high cost. At Denim North America we have one of the reasons that I elected to go back into this business; this is a new state of the art facility. It has cutting technology that will compete with anyone in the world. We have—and everyone talks about labor cost. I can tell you in a state of the art manufacturing facility such as Denim North America, labor is less than 12 percent of your cost. So, moving those jobs to cheaper labor is not the answer.

What I am concerned about, as you have watched what has happened in the last year, in 2002, China's export of apparel into this country has increased by 117 percent. Through May 2003, it has increased another 120 percent. What is happening in this country is that even though we have alliances with our friends in the Caribbean and in Mexico, where we have access to duty free garments, we are still unable to compete. Something is wrong with this picture. When you take your costs down, when you are able to buy assets for virtually pennies on the dollar and you still cannot compete, something is wrong, and I submit that is the currency manipulation.

Now if you think who are the largest consumers of apparel products, which country consumes most products? This Nation consumes more textile-apparel products than any other nation in the world. I want this Committee to know that I understand that if we had this field level where we competed in fair trade and if what we are doing today is competing under the disguise of free trade, would apparel products be more expensive? Absolutely. They would be more expensive. The retailer would pay more. I am the first to admit that.

We are big in the jeans business. If you think denim production and denim sales in this country last year grew, yet denim production sold out of U.S. textile companies declined dramatically. There is not a company in North America today that is operating anywhere close to their full capacity and when you operate at reduced schedules it increases your cost, and if something is not done soon to deal with this currency differential because they buy U.S. cotton—remember under the NAFTA Agreement we must buy U.S. cotton, and I fully support that because we support our farmers in this country. We must buy U.S. cotton. We must certify that all the yarns and cotton that go into fabrics are NAFTA or Caribbean Basin Initiative friendly, and yet we are still not able to compete.

Something is wrong and if you look at the cotton exports this year, over two-thirds of the cotton produced in this country will be exported to the Asian countries. China has surpassed Mexico, our trading partner for apparel, as the largest exporter of textiles and apparel into this country.

I am concerned about the future of this industry. There are 630,000 people employed in this industry and unless something is done I am afraid that if this continues at this rate, by the year 2006 most of these jobs will go away.

I again commend this Committee for taking time to listen to this. Give us the opportunity to talk about it. We support free trade. We support more fair trade and we ask that you look and that the—remember when we agreed to join the WTO we were told at that time as an industry don't be concerned because if your industry is disrupted there are safeguards that will be implemented to protect that industry to keep from disrupting your industry. I submit that these safeguards need to be enacted and that we need to deal with the China import issue in the textile-apparel industry as soon as possible. Thank you.

[The prepared statement of Mr. Galbraith follows:]

Statement of Larry L. Galbraith, President and Chief Executive Officer, Denim North America, Columbus, Georgia

First I would like to thank Chairman Thomas and Ranking Members for holding this hearing and affording the opportunity to testify.

Denim North America produces denim fabric for most major denim brands sold in the U.S.A. Our company employs 240 at it's manufacturing plant in Columbus, Georgia.

Georgia's textile industry today employees 89,000 which is 25,000 fewer than just five years ago. These 25,000 jobs have vanished to China, India, Pakistan and Viet Nam, just to name a few countries. These Georgians were not put out of work because our industry continues to invest heavily in world-class manufacturing technology. Certainly, our industry's productivity has increased as we've invested to protect jobs and better serve our customers. And this investment should have enabled the industry to increase its share of the U.S. market and export its products throughout the world, especially to Mexico and the CBI countries. The evidence that the rising productivity of the U.S. industry is not to blame for the job losses is clear in the dramatic increases in textile and apparel imports from China-which more than doubled in 2002, growing by an astounding 117 percent. China's exports have continued to skyrocket in 2003, up an additional 117 percent through May. China's U.S. market share in apparel categories that have been removed from quota jumped from 9 percent in 2001 to 53 percent in 2003. The fact, not the rising productivity of the U.S. textile industry, accounts for the massive job losses.

Denim North America's facility has the latest cutting-edge technology equipment in this hemisphere if not in the world.

Fabric produced in Columbus Georgia is shipped to Mexico, Guatemala, etc. to be cut, sewn and shipped back to the U.S.A. retailers. All yarn and cotton used must be certified to be N.A.F.T.A. or C.B.I. friendly, meaning only U.S. cotton and yarn must be used.

Each Quarter in 2003 Denim North America has lost sales. China furnishes finished garments to retailers at two to four dollars below the prices for identical garments produced in C.B.I. or N.A.F.T.A. countries.

China has surpassed Mexico as the largest exporter of textile and apparel to the U.S. market.

In 2002 Denim North America primarily produced denim fabric for women and kids jeans. Today, the kids and women's stretch jeans are imported in garment form from China (again, two to four dollars below N.A.F.T.A. and C.B.I.).

Denim North America has taken a very aggressive approach to try to be competitive with Asia's full package garments. To retain some women's and kids fabric, Denim North America, in conjunction with cut-and-sew producers in Mexico and Guatemala, sold garments at no profit to maintain a small market share. For example, stretch denim that sold in 2002 for $4.35 a linear yard, is now being sold at $3.15 a linear yard. Yet, for the most part we retain only a very small share of these two markets.

Other denim producers in the U.S.A. have closed operations or have filed bankruptcy. Swift (Galey and Lord), Cone and Burlington are all in bankruptcy. Avondale has closed three plants this year. Cone has closed two plants and Swift has terminated about half of its workforce, resulting in over 100 million yards of denim production going away in 2003.

Remember U.S. denim producers must use all U.S. cotton yarn, which I support because it helps the farmers in this country. Cotton yarn is the largest cost U.S. fabric producers have. About 50% of fabric cost is U.S. Cotton yarn.

Denim North America has a very low cost base with cutting edge technology and yet we continue to lose market share.

Many think lower wages are the reason for the price difference; I submit this is not the case. In a world class manufacturing operation like Denim North America, wages are only 12% of total cost.

China's rapid surge into our market is aided by pegging of the yuan to the U.S. dollar. Currency manipulation has allowed China to gain an unfair price advantage in our market. Despite the presence of relative high duties and the ability of product produced in Mexico, Central America and the Caribbean to get duty-free advantage, China has rolled into the U.S. Market at an unstoppable speed and increased volume each quarter of 2003. How else can this happen other than currency manipulation and state subsidy programs?

Denim North America has experienced appx $12,000,000 loss of sales for the first nine months of 2003 resulting from unfair competition. Our employees are experiencing time off and lost wages as a result.

I urge you to ask President Bush to inact the Safeguard Provisions agreed to by China to get the U.S. to okay their joining the W.T.O. However, it will ultimately be necessary to restore a fair competitive market place after safeguards.

China's current monetary manipulation will displace thousands of U.S. workers as well as thousands of jobs in important North American countries such as Canada, Mexico, Guatemala, Honduras and the Dominican Republic.

The U.S. market is the market place China wants to dominate. The United States is far and above the world's largest textile and apparel consuming Nation.

Thank you for your sense of urgency, as each month passes more and more manufacturing jobs are lost in this country.

While we support Free Trade, **Fair** Trade is what is important!

We must always ask ourselves "Are the decisions we make today good for our grandchildren tomorrow"?

Thank you for your time and I welcome any questions that the Committee has regarding the affect of China's trade practices on the textile industry.

Mr. PORTMAN. Thank you, Mr. Galbraith. I would like to take a moment if I could do introduce a constituent of mine, Mr. Jeb Head. Jeb is here with his wife, Nervoni. He is an entrepreneur in the Cincinnati area. He is President of Atkins & Pearce, which is a small manufacturing company of industrial textiles that faces competition from China on a daily basis. This business was begun in 1817. He is the seventh generation to operate the business. It provides employment and opportunities to over 230 greater Cincinnati workers and their families. He is on the frontlines of this economic battle, and he has impressed me with his writing and his speaking out on the currency issue in particular. He has addressed it in a very thoughtful manner and we are delighted that a small manufacturer will be here on that issue today. I am pleased to have your testimony, Jeb.

STATEMENT OF JEB HEAD, PRESIDENT, ATKINS & PEARCE, INC., COVINGTON, KENTUCKY

Mr. HEAD. Thank you, Mr. Chairman, and thank you, distinguished Members, for giving us the opportunity to speak here today. I want to start by saying that as Americans we all support and respect the aspirations of the Chinese, but at least so far in this hearing, I don't feel like we have heard the kind of imbalances that really exist in the U.S.-China trade relationship.

As my associate here mentioned, in manufacturing the labor costs are between 12 and 25 percent. If it was only cheap labor we would be able to compete. The Chinese have to bring their product halfway around the world and between shipping costs and other logistics costs that would be a level playing field. We could compete on quality. We could compete on deliveries and we could compete on services.

The fact is though that there are massive subsidies that are on Chinese products from the Chinese Government. We have heard about currency manipulations that are in the 20 to 30 percent range. We have heard about VAT rebates that are in the 12 to 18 percent range. Altogether this represents 40 percent in terms of subsidies to Chinese products.

Now in industrial markets you don't have 30 or 40 percent margins. That is devastating to industrial markets. The playing field is like this and jobs that would otherwise stay in America, manufacturing infrastructure that would otherwise stay in America, and technology that would otherwise stay in America is draining into China as a result of these subsidies.

Now, with all due respect, I will say that these subsidies help a lot of people in the United States. It subsidizes many corporations' profits. China sends over $140 billion worth of material here, and if you accept that 40 percent subsidy number that means there is nearly $60 billion of subsidies applied to those products. Frankly, that buys a lot of friends and it will get a lot of people to say it is a good deal, but it is not a good deal.

I would say in closing that U.S. manufacturers are facing tremendous challenges. We are losing a vital part of our heritage. I was talking to a business editor at a major metropolitan newspaper and she told me she didn't think this would be an election issue. She said it was too complicated for people to understand, and I want you to know that people understand this issue more and more and more. We are suffering in manufacturing. It is not right. I think history will look back at this period and say this is one of the biggest policy mistakes that we have ever had. The time for baby steps is over. We need real action, real action not on the little issues but on the big ones. The currency, the VAT, we need action. Thank you very much.

[The prepared statement of Mr. Head follows:]

Statement of Jeb Head, President, Atkins & Pearce, Inc., Covington, Kentucky

Atkins & Pearce is a manufacturing company, which produces cordage and sleeving for a wide range of industrial uses. We employ 235 people, and have been a family owned and operated company since 1817. We have a great heritage. We have survived a Civil War, two World Wars, the depression, recessions, stagflation. . . . Now, we face a threat that may exceed all that we have seen. Our business and the business of my customers and suppliers have been dramatically affected by the predatory trade policies of China.

China's Century

We are witnessing the unfolding of the "China Century", just as we will come to terms with the twilight of the "American Century". Within twenty years, China will be the largest economic power on earth. Additionally, as evidenced by the recent manned space flight, China will also likely gain parity if not military superiority.

Commentators covering the recent APEC summit observe that China has already largely displaced the US in terms of regional influence in Asia. To be sure, China is a vast country with a palpable yearning for advancement, status, and dignity. Unfortunately, these ambitions have degenerated into a trade policy regimen that is astonishing in its imbalance, and dangerous in the inevitability of disaster.

As Americans, we must respect and support the aspirations of the Chinese people, even as we embrace the realities of the world in which our children and grandchildren will live.

A part of embracing future realities is a frank assessment of the current dynamics of China's relationship to the US, and the rest of the world. The pressure on the Chinese leadership to create jobs is intense. However, taking US industry, jobs and technology through the adoption of predatory trade practices, is a solution we should not accept. We should compete on a level playing field.

Predatory Trade Policies are Unmistakable

While there are those who seek to defend the trade policies of China, nobody should be fooled by what is a comprehensive scheme of predatory trade practices. These practices amount to a Chinese Government buy-out of US manufacturing jobs.

The largest component of the China/US unfair trade practice is the subsidized Chinese currency. The Chinese buy $600 million dollars a day to keep their currency deflated by 40%. This is a fact. This deflated Chinese currency has given Chinese goods an overwhelming price advantage against American goods, which has led to a huge trade deficit of $120 billion, which is growing at 30% per year, as well as a staggering loss of US manufacturing jobs.

There is also a Value Added Tax rebate to Chinese companies from the Chinese Government that amounts to a generalized export subsidy, making Chinese products more expensive in the Chinese market than they are for export to the US. This VAT program is funded by $30 billion annually, and amounts to an additional 18% price subsidy across the board. These manipulations give Chinese producers an astounding pricing power advantage that far exceeds the advantage that comes from cheap labor.

US Manufacturers typically have labor costs of between 15% and 30% of sale price. Cheap labor certainly is an advantage, but shipping costs, and duties largely offset the labor advantage. If the labor differential were the only factor, a vast proportion of manufacturers could easily compete by improving efficiency, providing higher quality product lines, and importantly, by providing shorter lead times and better service.

However, the currency manipulation, VAT subsidies, and other direct unfair practices currently supported by the Chinese Government make it impossible for companies producing in the United States to compete. These subsidies add an additional 30% to 40% advantage to Chinese goods, on top of the cheap labor advantage. US Industrial products do not have 30 or 40% margins, and therefore cannot absorb these pricing disadvantages.

> ". . . There is one, and only one, explanation of what's going on when a country amasses more than $300 billion in foreign-exchange reserves: This is currency intervention on a massive scale to depress the value of the currency—to favor exports and restrict imports. These effects are identical to a tariff on imports and a subsidy to exports. I yield enthusiasm for free trade to no one, but this is not free trade. It is explicit government intervention in trade by the back door."
>
> Lawrence G. Franko, Professor of International Financial Management, University of Massachusetts

The China Economic and Security Review Commission, which has been charged by Congress "to help better understand the almost tectonic economic forces now shaping the U.S.-China economic relationship", offers the following:

> China continues to follow a policy of one-way market interventions by the government to maintain its currency at a level that economists estimate is between 15–40 percent undervalued.—China, in violation of both its IMF and WTO obligations, is in fact manipulating its currency for trade advantage.
>
> Manufacturers in China are supported through a wide range of national industrial policies, which include: tariffs; limitations on foreign firms' access to domestic marketing channels; requirements for technology transfer by foreign investors; government selection of partners for major international joint ventures; preferential loans from state banks; privileged access to listings on national and international stock markets; tax relief; privileged access to land; and direct support for R&D from the government budget.
>
> China's undervalued currency and government investment strategies are having a deleterious effect on the competitiveness of U.S. manufactured goods and contributing to a migration of world manufacturing capacity to China, with a concurrent erosion of the U.S. manufacturing base.

It is not disputed that some portion of US industry will continually shift to low wage areas when barriers are lifted. Nor is it disputed that free trade raises incomes, and benefits society in general. But anyone who doubts the degree and intensity of the imbalance and deliberate unfairness in China's trade policies at best has their eyes closed, and at worst is benefiting from the imbalance, and purposefully denying the facts to create confusion.

Long Term Losses of Industry, Technology, Prosperity

The artificial and unsustainable pricing power that China achieves through this comprehensive regimen of unfair predatory trade practices has, and will continue to "steal" a larger share of the US industrial base than "free trade" economics would justify at equilibrium.

The incremental industrial share that goes beyond what "natural" economics would shift to China is a huge and long-term loss to the US. Critical mass is a critical concept.

New York is the home of global finance, Detroit has historically been an automotive center, Pittsburgh retained a global advantage in steel for over a half a century, and the Carolinas have, until recently, led the world in textile production. These activity centers have been based on an initial lead that developed into a cumulative build-up of technology, infrastructure, supply chain, and skill base. This kind of industrial critical mass feeds upon itself, and nourishes a long-term sustainable industrial base.

When you artificially decimate an industry, or the entire industrial base, you lose that critical mass. It doesn't come back. If the decimation is based on artificial pricing power, it does not return once the artificial advantage is lifted. By tilting the playing field, the Chinese are gaining critical mass in terms of infrastructure and technological know-how that they would not have gotten on a level playing field. But once expropriated, the industrial infrastructure and technology will not return.

The reverse effect occurs in America. As industries are gutted, skill and expertise is lost, workers with experience are dissipated, economies of scale evaporate, research and development becomes unsustainable.

The electrical circuit board industry is a good example, among many. Over the space of just a few years, vast chunks of this industry moved to Taiwan and China. The move was utterly fueled by massive government subsidies. Now that it is gone there is no chance that it will return—even if the playing field was leveled. The skill base, network of suppliers, R&D centers, equipment businesses that supported this industry have simply died on the vine.

When our manufacturing base is growing, we benefit from a "multiplier effect". That is, every $1 of final demand for manufactured goods generates an additional $0.67 in other manufactured products, and $0.76 in products and services from non-manufacturing sectors. Therefore, each $1 of manufactured goods equates to $2.43 of total economic activity. This multiplier is the highest of any economic sector. Nearly triple that of the Financial Services sector. (NAM Report: "The Case for a Strong Manufacturing Base", by Joel Popkin, 6/03)

Of course, the opposite is also true. When you destroy vast chunks of your manufacturing base, you suffocate allied producers and service providers; thus, for every $1 of manufactured product lost, the economy actually loses a total of $2.43 of economic activity. Lost jobs, lost skills, lost economies of scale—a downward spiral.

This Process Will Not Stop, or Slow Down. It Will Accelerate.

As stated above, manufacturers do not have 30% or 40% margins. If the labor differential out of China was the only factor, a vast proportion of manufacturers could easily compete. But given the scale of the imbalance there is little that can stop a continued and accelerating loss of manufacturing base to China.

An entire industry has grown up around that process of transferring infrastructure and technology to China. Today there is a growing legion of consultants that can assist and support the process of either moving your operation to China, or sourcing your supply base out of China. There are now dozens of "Private Equity" firms that can even buy the stock in your company. They then do all the dirty work of shutting down the US operation, and moving it to China.

When an incentive this huge is offered, the market reacts. The infrastructure that has developed to accelerate this process has only recently achieved critical mass. Two years ago, you had to be a real pioneer to access China. Today, bailing out of the US is just a phone call away.

Many manufacturers don't like it. Particularly, small and medium sized firms have a loyalty to their people, and their nation. But they have a gun to their head. It's a game of chicken. If one of your competitors bails out first, you will be left unable to compete against the Chinese product that is so extensively supported by the Chinese Government. I have heard a number of times, from manufacturing associates, "I don't like it, but if I don't, somebody else will."

So it will accelerate—until the playing field is leveled. On a monthly basis, Chinese imports are at roughly $12 billion and growing at 30% year on year. US exports to China are about $1.8 billion per month, and growing at 15%.

> "In one industry after another—clothing, furniture, light electronics—domestic manufacturers unable to match Chinese prices have gone out of business or shifted production abroad. A recent study done for a congressional panel found that at least 760,000 U.S. manufacturing jobs have migrated to China since 1992." (Los Angeles Times October 20, 2002)

Reliable estimates suggest as many as 7,500 to 10,000 jobs are lost with each $1 billion increase in our trade deficit with China. The deficit with China is growing by $2 billion per month.

Wait! Don't Worry. We Can *Spend* Our Way to Prosperity.

In the midst of the manufacturing blood bath, we have begun to celebrate the return of economic vitality. GDP growth is strong, and strengthening. So everything is OK, right? This is a terrible misreading. We are becoming a nation of highly indebted consumers. Isn't it great for our country to have access to such fabulous prices!

The current economic regimen is exclusively focused on consumers and consumption. There are three legs to the stool that is propping up consumers. First, there is the Federal deficit, which pumps dollars into the system through tax cuts and increased spending; secondly, there is an extremely stimulative monetary policy, which provides low interest rates that increase borrowing; and finally, there is massive subsidies on consumer products from China and other Asian nations.

As housing prices, which are fuelled by low interest rates, continue to soar, consumers can borrow more and more under their home equity lines. This allows them to buy more stuff. The savings rate in the US is at historic lows, and among the lowest in the world.

While we are tempted to think all is well when reports of increased economic activity are broadcast, all is not well. The vision of a highly indebted, consumer society, where there is no manufacturing, no real value produced, where we all "service" each others' needs, in an all-service economy, is as hollow as any vision could be.

Willing Accomplices

There are many who argue that the outcry from American manufacturers is misplaced. That it is merely protectionism. Clearly, there are two camps in this debate. Large multi-nationals and investment banks, as well as the Chinese themselves, have thrown out theory after theory, rationale after rationale, to confuse the issue, and perpetuate the status quo.

We shouldn't be surprised. These companies are already heavily invested in China, and enjoy the benefits of China's subsidized currencies in pricing their products. Consider Walmart. Walmart buys roughly $12 billion from China. The currency manipulation factor alone, which depresses the value of the Yuan by 20% to 40%, yields Walmart a savings of between $2 and $4 billion dollars annually. This makes Walmart the price competitive place to shop, displacing American manufacturers of their goods, and this savings increases Walmart profits and executive bonuses as well.

Selling Out?

When one considers the role Walmart has had in transferring American jobs to China, it is staggering. It is particularly ironic that Sam Walton's biography is titled "Made in America." In it he explains his policy of buying from local producers. He reasoned that if Walmart bought from local producers, the people surrounding the stores would have money to buy things at Walmart. At one time, Walmart did buy mostly American products. However, that has changed.

Consider a Harvard Business School case study on Walmart circa 1995 (shortly after Sam's death). The study covers Walmart's 1994 entry into China. At that time Walmart's plan appeared to have been to set-up retail in China. The case quotes, "Walmart carried more than 1000 different branded products, most items are directly imported from America representing the best sellers in many categories . . ." (HBS case 9–795–118)

Today, while Walmart's retail operations in the Far East are modest, Walmart imports an estimated $12 billion in goods from China. So instead of selling in China, they are buying in China. A WSJ article suggests that Walmart buys 70% of its goods from China—all subsidized by the Chinese Government. (Low Value of Yuan Helps Companies Dependent on Cheap Manufacturing, WSJ 9/4/03)

So what happened to the 1000 American brands that they were going to take to China? Do we imagine that when they got there, Chinese producers just happened to have exact duplicates of their American supplier's best products?

It would appear that Walmart shifted focus from selling to buying, recognizing that the currency subsidy gave them a massive potential competitive advantage. It seems only too likely that, product-by-product, Walmart took some 1000 leading indigenous American products to China, and arranged to have them copied in China. Perhaps they gave them the specifications, assisted in setting up production, and arranged the delivery under guaranteed orders. Now the American companies are out, and Chinese firms have set-up to capture the business.

There is certainly nothing illegal about this activity. But the selling out of the domestic supply base seems at odds with Sam Walton's original vision. Walmart accepts vast subsidies from the Chinese Government on Chinese products. Profits are boosted, and Walmart gains large chunks of market share with low pricing made possible by the subsidies. China benefits by getting the business, and can proceed to build industrial capacity to displace the US capacity, assisted by a clear view of the products to be duplicated. And finally America loses as domestic companies are driven out of business, and manufacturing employees lose their job. Walmart is the rogue-purchasing agent of America, Inc., who benefits individually while damaging the broader enterprise, and China is the vendor buying the business by subsidizing Walmart's profits.

The Walmart effect may be larger than it first appears. Europe's trade deficit with China is much smaller than ours (less than $20 billion). While this has a lot to do "strong dollar policy" in the US over the past ten years, it is clear that Walmart provides an amazing portal into the US market. And what Walmart does, other retailers are forced to do as well.

The China "Bubble"

There can be little question that the trading regimen that the Chinese have developed is very deliberate. It is costly, but the acquisition of global manufacturing infrastructure is the goal. The means to this end are utterly predatory trade policies.

However, there is a huge risk in pursuing this course for China and the world. Many of the apologists for China want us to believe that it is the US that risks destabilization by calling for an end to the currency peg. However, it is clearly China that is driving an unprecedented and wild ride toward a global supply bubble.

There is no better source for illuminating the 'irrational exuberance' that is fanning throughout China than this excellent article, which is excerpted here:

Surge in Lending In China Stokes Economic Worries

Spending, Investment Sprees Point To Overheating; Bad Debts Rise

By KATHY CHEN and KARBY LEGGETT Staff Reporters of THE WALL STREET JOURNAL 10–3–2003

Liu Yijun is 27 years old and works as a real-estate agent. He and his wife, a supermarket purchasing agent, together make about $8,000 a year. On that modest income, this year they've bought a new Mazda for more than $19,000 and a new apartment priced at almost $91,000. How did they do it? "Bank loans changed our life," Mr. Liu says.

China is awash in easy credit these days, spurring a national spending and investment spree . . . Pessimists point to overproduction in steel and a possible asset bubble developing in property. They worry that economic growth can't be sustained at its current pace. What's more, economists estimate that of China's nearly $2 trillion in outstanding loans, between $500 billion and $750 billion aren't expected to be repaid. Those amounts are in line with Japan's bad-loan problem . . .

. . . The lending boom has roots in an economic-stimulus program that Beijing began in the late 1990s after the Asian financial crisis. It promotes government spending and easy credit to stimulate growth and generate jobs. The program has called for issuing large amounts of government debt, seriously widening the country's budget deficit—$37.39 billion last year, compared with $2.5 billion in 1993.

The country's tightly controlled foreign-exchange regime also plays a big role in the flow of credit. But maintaining this fixed exchange rate often puts China's central bank in a difficult position: For every dollar from exports and foreign investment that enters China—a total of $378 billion last year—the bank must supply an equivalent amount of yuan. Since there is more money entering China than leaving it, the supply of yuan keeps rising. China's money supply surged 21.6% as of the end of August over the same time last year.

> The government has resisted revaluing the yuan or ending its policy of pegging it to the dollar, even after warnings earlier this year from Federal Reserve Chairman Alan Greenspan that the yuan's fixed exchange rate could make China's economy overheat . . .
>
> . . . As the cash piles up, Beijing is pressuring bankers to put the money to use. . . . [making] new loans totaling $60.4 billion for the first eight months of this year and accounting for 23.1% of total new lending. Banks have become so eager to lend that they often conduct only minimal credit checks and impose minimal penalties for delinquencies . . .

The Peg Drives the China Bubble

For anyone who has been in China, the pace of growth is truly "crazy". The currency is undervalued, and driving a near hysteria of investment in production infrastructure, as well as real estate.

The currency peg results in two avenues for irrational exuberance. On the one hand, it creates uncontrolled growth in the supply of money, which leads to out-of-control and poor quality loan growth. On the other hand, it causes Chinese entrepreneurs to think they are unbeatable. The artificially perceived pricing power that derives from the pegged currency drives unchecked speculative production capacity growth for export. The fallout from these distortions will be great.

Millions of job seeking Chinese stream toward the eastern manufacturing zones, where entrepreneurs, who did not exist before 1992, take out ever larger loans, to fund hyper growth of manufacturing infrastructure, while exports grow at 30%, driving 70% of all economic growth in China.

Meanwhile, China amasses a $120 billion trade surplus with the US, which is growing at a rate of 28% per year. There is massive daily intervention in the currency markets to defend their undervalued currency, driving their total foreign dollar reserves to $360 billion (one third of their total annual GDP). This strain comes upon a banking system that has 40 to 50% non-performing loans, and where loan growth is 30% per year, many of which will become non-performing.

This is not a complicated economic principle. Chinese hyper-competitiveness is artificial. And the fundamentals amount to insanity. The Chinese are grabbing global market share in manufactured goods with heavy subsidies and non-market advantages in the form of the currency peg, and export subsidies that total over 40%. The artificial pricing power is stimulating unprecedented growth in global manufacturing capacity. False market signals lead to oversupply, which leads to long-term deflation. When this bubble breaks, everyone will say we should have seen it coming.

It is useful to reflect on the Internet Bubble in this context. Many feel rather foolish for believing the hype. Some have gotten in trouble for supporting it. But most certainly would agree that we all suffered from a collective delusion.

But think. In the US we have an utterly free press, well functioning capital markets, an SEC that regulates securities markets. We have a heritage of corporate transparency. There are very venerable and trustworthy accounting firms, that certify accounts based on well-established accounting principles. There are analysts that analyze, and a broad swath of experienced investors, making decisions that are very purely driven toward making the right call.

While the Internet fiasco has caused us to call into question many aspects of the integrity of our system, there is no comparison to the Chinese system. Yet we fell prey to the Internet Bubble.

In China, there is little transparency. No free press. There is significant corruption through the ranks of government. The banks are in terrible shape. Lending is out of control . . . To pursue the rapid overheating strategy that the currency peg drives is bound to lead to a Bubble that will make the Internet bubble look small, and this will end up serving nobody.

But many cry out that China cannot abandon the peg because that would cause havoc on China's delicate economic balance. The truth is that the peg is inflicting the damage. Alan Greenspan, when he testified at the July senate banking committee, called the manipulation "unsustainable", and said that the peg would deteriorate the China's monetary system. [FT July 17, '03 ". . . Mr Greenspan suggested that the renminbi would have to be allowed to float, saying the current campaign of intervention to support it was unsustainable. "It has required them to be very heavy purchasers of US dollar-denominated assets," Mr Greenspan said. "At some point they will no longer be able to do that, because it will create an inability of their monetary system to function well. . . . And I think the Chinese are sufficiently sophisticated to understand that."

Yes. It is true that when the Yuan appreciates, there will be tough economic consequences. But that is the only path to a healthy global economy. (It is also inevitable). Those who argue against such a course, like the late stage internet analysts, are just trying to get everyone to keep their money in, so they can get their money out.

But What if They Stop Buying Our Bonds

There is a buzz that there is danger that the Chinese would stop buying US bonds in the event of a currency appreciation. This apparently will ruin everything.

Here again we see a Wall Street that is only interested in Wall Street. It has to be put in sequence. The Chinese buy a disproportional amount of US debt, because they have a disproportionally large amount of dollars. They have the dollars because of an artificially large surplus, and they have the surplus because of an undervalued yuan. They will always have dollars in proportion to the trade surplus. If the Yuan appreciated they would have less dollars to buy bonds, but there would be a lower trade deficit for the US to finance. This is in the right direction.

The idea that the Chinese might get mad, and do something else with their dollars does not hold water either. They could sell the dollars for euros and yen and invest in euro bonds and yen bonds. Of course that would cause the dollar to further weaken, and would strengthen the Euro and Yen (essentially transferring the yuan's strength to the euro (yen)). This would simply aggravate China's problem.

Also, buying the bonds (particularly on the long maturities), extends the stimulative US monetary policy out to the home equity lines, and as a result, the stimulative regime of the Fed is angled more toward consumer spending (as it puts money in consumer pockets). This is to say that there is a relatively unmediated connection between China bond buying and US importing of Chinese goods. They have little incentive to stop financing the purchase of their goods.

The Voters Will Understand This Issue

As we look at this debate, we see the two sides. On the one hand, the very few—the corporate executives and agents that profit by exploiting the lucrative subsidies offered by China. All they have to do is sell out their workers, and give up America's technology, and America's future. They are well positioned to dominate the debate. They have access. They have big profits to protect. On the other hand, the very many—those who work in manufacturing companies, and those who are supported by their jobs. They are good at what they do. By combining brain-power, and the art of their hands, they reach their highest potential. But they have little access, and little expertise in the affairs of international finance.

There are some who bet that the many will never understand this issue. But already, the truth is coming clearer and clearer. In January of this year there was virually no news on this subject. Today, each week, across this country, dozen of articles are written—and being read.

MEMBER EXCHANGE: Manufacturing an endangered species in NJ
phillyBurbs.com

Alamance County textile leaders brace for a potential flood of Chinese goods
Jan. 1, 2003 Times-News

US Trade Chief to Push Fair China Trade
Reuters

Mexico treasury secretary: Global economy too dependent on U.S. growth
San Francisco Chronicle

Who wins when jobs move offshore?
CNET

Job Losses, Bush's Risks Rise
Los Angeles Times

A.T. Cross: Jobs to be transferred to China
Pawtucket Times

Their unemployment assistance exhausted, Wichita's laid-off workers struggle daily to make ends meet
Wichita Eagle

Fortune 500 taking U.S. jobs overseas
Sun-Sentinel.com

Letters: America's trade policies are not working
Rocky Mountain News

This is a small sample of how this story is fanning out across America—from Pawtucket to Los Angeles, Miami to Chicago, Roanoke to Oshkosh. We will not be confused. We will not be called protectionist. America will fight to save its future. Anyone running for President would be wise to put aside the empty arguments of those who seek to keep the status quo. We need to do the right thing.

> There is a growing recognition that executive pay is so high, and so linked to profits, that many are willing to defend the corrupt system at any cost.
>
> "Thanks to the overpaid CEOs, I am going to have to try to explain to my children why Daddy doesn't have a job. I'm going to have to explain that the company I worked for would rather pay the CEO millions of dollars, plus stock options, than keep American workers employed. What I am going to teach them is that Americans must buy American-made products, or we are not going to have any jobs left in this country. I am going to teach them that greed is one of the greatest evils there is. That we must fight for and protect what is ours. Go ahead, Raytheon, send my job to a Third World country and exploit their people. Because one day, you will wake up and find that there is no one left in America who can afford to buy your product—and then you will be the outsourcing victim!

DON TERNES
Wichita Eagle, Posted on Tue, Sep. 16, 2003

Section 2: Responding to those who cry "protectionism!"

There are a number of vocal defenders of the Chinese currency regime, which again, is not all that surprising. If we consider that the Chinese currency is undervalued by let us say 30%, then the currency effect of the $140 billion in goods that are imported amounts to $42 billion. That is, the companies that are importing the goods are benefiting from $42 billion in subsidies that result from China's massive daily currency manipulations. The record $52 billion in foreign direct investment flowing into China is also benefited.

This kind of largess helps China make good friends, and those who defend the current highly imbalanced trading regime have come up with a full range of theories and rationales to defend the status quo. Let's look at a few. The first thing one notices is a strong "offense through arrogance". This is to say that we are repeated buffeted by the claim that exchange rate economics are far too complicated for almost anyone to understand—so most of us should just butt out. Consider Robert Bartley's "Exchange Rate Primer" from the WSJ (9/29/03):

> "The American political elite knows almost nothing about exchange rates. Worse, much of what it does know is wrong. This wouldn't be so bad if presidents, congressfolk and Treasury secretaries were content to leave the issue alone, but recently they've been listening to the whining of a curious coalition of protectionists, anti-China zealots and beleaguered manufacturers. So herewith a primer, aimed at dispelling myths that befog the issue . . ."

Bartley moves to explain that the Chinese apparently are not as confused as to the proper economics behind exchange rates . . .

> ". . . floating represents the absence of a policy. A fixed rate is a policy. The central bank of, say, China uses the exchange rate as a policy target; if the yuan starts to rise against the dollar, it creates more of them; if it falls it creates fewer.

So we are supposed at this point to understand that really only the Chinese and Wall Street understand the proper disposition of exchange rates. Bartley then claims that the law of one price means that currency manipulations simply have no effect . . .

> ". . . Say $1 is worth 8 yuan and each will buy a bottle of wine. Then say the exchange rate changes to $1 for 6 yuan. Suddenly the wine will sell for $1 and 6 yuan. This arbitrage happens instantly with widely traded goods such as gold, and only over time with untraded goods such as haircuts. But it will defeat attempts to sell more abroad by devaluing your currency . . ."

So Bartley instructs us that commodity prices react so "suddenly", or instantly, that exchange rates make no difference. However, the fact that over the past year both the Euro and the Yen have changed value against the dollar, while the Yuan has remained at exactly the same valuation means that by reference something has not adjusted.

The undermining of Bartley's claim is more precisely achieved in "Currency Devaluation: Sometimes It Works" by John V. Deaver, Former Chief Economist at Ford Motor Co., Dearborn, Mich. (WSJ 10/17/03).

Excerpt: ". . . Robert Bartley's "Exchange Rates: a Primer" (Thinking Things Over, Sept. 28) is generally sound, but makes an error that is common even among **non-specialist** economists: ignoring the importance of capital movements and the bookkeeping equality between the current account and the capital account in the balance of payments. Thus his "law of one price" argument suggests that no country can long benefit from a predatory exchange rate policy. . . . **Whether the balance is "good for the country" is hard to measure; whether it is "fair" depends on whose ox is gored; what to do about it is debatable, but whether it happens is not."** *Updated October 17, 2003*

Bartley finishes up his piece with the reaffirmation of his basic premise. That Wall Street and China are the only folks qualified to understand exchange rates, and that utter catastrophe awaits the entire globe if someone like a Congress folk or Treasury Secretary does anything but ignore the issue totally.

". . . All of which is to say that when Treasury Secretary John Snow makes himself point man for the devaluationists he is an innocent playing with matches. . . . Clearly the Administration's confused stance toward the dollar is a political calculation, intended as a display of doing something about the "jobless recovery."

With Friends Like These . . .

Stephen Roach, Chief Economist for Morgan Stanley, has also weighed into the debate. It is important to fully understand Mr. Roach's arguments, because he has been outspoken, has claimed the intellectual high-ground, and his ideas have resurfaced time and again throughout the debate. In "The Scapegoating of China" (US Investment Perspectives (USIP), 7/16/03), Roach explains that ". . . I urged the Chinese to stay the course—to leave their RMB policy unchanged. I offered three reasons in support of this conclusion . . ." These arguments were written in a Financial Times Op Ed piece, and have been echoed in The Economist, and Business Week. His first argument as recounted by the Economist goes as follows:

". . . American manufacturers accuse Chinese firms of stealing global market share. Yet Stephen Roach, chief economist at Morgan Stanley, points out that two-thirds of China's export growth since 1994 has come from the subsidiaries or joint ventures of foreign multinationals. China's export boom is partly due to efforts by rich-world firms to remain competitive. Had these firms not invested in China, they would have been less profitable and might have hired fewer workers at home. A large revaluation of the yuan could hurt them." (Tilting at dragons, Economist, Oct 23rd 2003)

Roach proclaims, "China's increasingly powerful export machine has America, Europe and Japan stamped all over it. This is hardly and example of China grabbing market share from the rest of the world. Instead, it is more a by-product of the struggle for competitive survival by high-cost producers in the industrial world . . . A high cost industrial world has made a conscious decision that it needs a Chinese-based outsourcing platform. Dismantling the RMB peg would destabilize the very supply chain that has become so integral to new globalized production models . . . By putting pressure on China to change its currency regime, the industrial world runs the risk of squandering the fruits of its own efforts . . ." (USIP)

Now of course the obvious critique of this argument is that just because the decision makers of major US, European and Japanese firms are complicit with the Chinese in exploiting the vast, and unfair subsidies offered by the Chinese doesn't make it right, or good.

In fact, it makes it worse. Looking back at the Walmart example, it's bad enough that they took the best American made products to the Chinese to have them copied. Copied under a subsidized regime that made it impossible for the American firms to defend their position. Do we now also find that Walmart actually provided the front money to set up the operations? Are we supposed to feel good about that?

Doesn't this actually dramatically accelerate the loss of technology that is perhaps the most damaging consequence of the predatory system? When Motorola shuts down a US facility, and ships the tooling to China, don't they also ship over the procedural manuals?

China wins, U.S. loses

For every 10 percent increase in U.S. FDI in China, there was a 6.3 percent increase in the level of imports from China to the U.S., with no statistically significant effect on the level of exports from the U.S. to China." Manufacturing News February 3, 2003

As we saw, Roach concludes his first point with, ". . . By putting pressure on China to change its currency regime, the industrial world runs the risk of squandering the fruits of its own efforts . . ." Of course the "squandering of the fruits" would result because changing the currency regime would raise the cost of buying from China. It would be a reduction of the subsidy.

For the second point, having argued that dismantling the RMB peg would destabilize the very supply chain that multi-nationals have built (i.e. that it would matter), Mr. Roach throws out the Bartleyesque argument that the exchange rate actually has virtually nothing to do with the trading system (i.e. that it doesn't matter).

> ". . . A second argument in support of China's currency peg is the nature of the nation's competitive prowess. Contrary to widespread perception, China does not compete on the basis of an undervalued currency. It competes mainly in terms of labor costs, technology, quality control, infrastructure, and an unwavering commitment to reform . . ." (Pause so I can wipe away the tears. (jh)) " . . . I have a hunch that if China were to revalue the RMB upward by 10%—a change I do not expect or advise—its exports would suffer little loss of market share." (USIP)

This argument seems to surpass the first in terms of both absurdity, and irrelevance. Roach glibly dismisses the full magnitude of the currency manipulation, which is generally thought to be more in the range of a 30% advantage. Further, the broader abuses committed by China include a 18% VAT rebate, tariffs; limitations on foreign firms' access to domestic marketing channels; requirements for technology transfer by foreign investors; etc., etc.

To suggest that a 10% change in the currency, which would raise the cost of Chinese goods by 10%, would not have an effect is dead wrong. Industrial markets are extremely competitive. Roach knows that. 10% exceeds the full pretax profit of most manufacturing firms. Certainly, a 30% to 50% advantage is overwhelming to industrial businesses.

Moving to the third reason Mr. Roach advised the Chinese to maintain their peg . . .

> ". . . Third, it's important to stress that there is little doubt over the endgame. China has consistently reiterated its long-term commitment to opening its capital account and making its currency fully convertible. At the same time, China knows full well that a good deal of heavy lifting on the reform front has to occur before these objectives can be accomplished. That's true of both capital market reforms and the need to clean up its banking problems. China is taking great strides on these fronts, but a lot more needs to be done. Until there is more progress on financial reforms, it would be premature and risky for China to float its currency, in my view . . ." (USIP)

Mr. Roach is indeed a good friend to the Chinese. Standing in full view of a clearly predatory trading behavior, which is causing the loss of literally millions of US jobs, and the bankrupting of hundreds of firms, he feels that we should continually support the predatory system because they need more time to reform their capital markets. Clearly, we should support China's efforts to reform its financial system. But there is no reason that US employees should lose their jobs permanently in support of such reform. Needless to say, from the vantage point of a US manufacturer, Mr. Roach's arguments are shockingly empty. But these very arguments have been picked up, over and over again.

Mr. PORTMAN. Thank you, Mr. Head. Mr. Somple.

STATEMENT OF JEFF SOMPLE, PRESIDENT, MACK NORTHERN OPERATIONS, MACK MOLDING COMPANY, ARLINGTON, VERMONT

Mr. SOMPLE. Mr. Chairman and Members of the Committee, I also would like to thank you for taking the time to listen to what I have to say today. After listening to what has just been said by my two colleagues, I know I am on the right panel.

Mack Molding is a company that was founded in 1920. It is also a family business, third generation, and basically what we do is provide plastic-sheet metal contract manufacturing and print circuit board services and parts, by far the largest which has been historically the computer and business equipment marketplace.

I will be relatively brief because I really only have one point to make and I think it has just been made relatively well.

I think we recognize that China has several advantages over U.S. manufacturing. They have low labor, the lack of regulations, for instance, no EPA, no OSHA. Things of that nature have been brought up, and I guess our point on that is fine. That is okay. That is the advantages they have. We have some of our own.

I think in terms of product activity, in terms of engineering, in terms of what we can bring to producing products, we have a lot of advantages as well, and I think all we are asking for is that the rules are the same for everyone playing the game.

A little historical section on what has happened to at least our company, and I think we are relatively representative of small to midsize manufacturers. I joined Mack in 1988. At that time we were a $35 million company. We employed about 300 people. From 1988 to the year 2000, a lot of challenges were thrown at us by the new global economy. One of the first ones, if you remember back in the 1980s and early 1990s, was you can't possibly compete on a quality basis with Japan. American manufacturing took that as a challenge and devised new systems, new training, new equipment, et cetera, and we met that challenge, and we were producing great quality.

There have been a lot of other buzzwords over the last several years, all representing challenges to U.S. manufacturers. One-stop shopping. Our customers wanted to have us vertically integrated so they could reduce their supply chain. We went out and made the appropriate investments to be able to provide that. Time to market, we have got to get our products from the drawing board into the showroom or into the marketplace quicker. We need you to help. So, we made investments again in a design company, in a prototype company. Just-in-time delivery, no matter where you produce Mack, if you want to produce it in the United States but when I snap my fingers, I want your product in my factory multiple times in the same day. Another challenge, another challenge met. We established logistic centers, distribution centers throughout Europe and the United States.

I guess the point I am trying to make is that we can compete, we can be creative, we can work hard. We can reinvest substantially all of our profits back into facing these challenges, back into facing these challenges the global economy has put on us, and the low cost has always been there. You guys have seen that. It has never been not present, and we have addressed that in a lot of ways. We have automated. Labor is a significantly low percentage of what we do.

We have deliberately focused on that, and by the year 2000 we were manufacturing products like mass storage devices, servers, deliberately concentrating on products that were large, bulky, difficult to ship, and had a relatively low percentage of labor cost. That was a strategy that was working, and by 2000 we employed over 2,100 people. Our revenues had grown to over $400 million when things were looking relatively good.

Coincidentally, with the weakening of the dollar right around the year 2000, a couple of our largest customers, three in fact, our three largest customers all announced they were going to set up manufacturing in China, and we were welcome to go join them if we wanted to, but they would no longer need to buy products from us. This was devastating. A lot of other customers followed, and it made no sense to us. We thought again we have done everything right. We have played by the rules, the challenges have come up. We have met those challenges, and yet for some reason we are losing the game and we don't understand why.

I certainly do not pretend to be an economist like the distinguished first panel had a few on. I am definitely not a currency expert by any means, but the net effect has been we have lost a thousand jobs, and those jobs are good jobs. They are factory jobs, they are well paying. They have full benefits. They have retirement plans. A lot of the people that I used to be able to wave to on the way to work now either don't have a job and they are looking for one or they have taken a job in the service sector or in some other type of work which may not even provide any health benefits or any retirement plans.

This is painful on a personal basis as well as a professional basis. When you work in small towns in America, you really become a part of the community, and it is very, very painful when you know that you are feeling as if you are letting down the people that count on you. If there is a currency problem of 15 to 40 percent, to echo what Jeb said, we don't have 15 percent to fool around with in our margins. Fifteen percent is huge. If there is a competitive disadvantage of 15 to 40 percent, we cannot compete with that.

I think we faced all the challenges that people have thrown at us by ourselves with ingenuity and with hard work. At this point we need some help, and I think what we are asking, and I really liked what I heard earlier from Congressman English, a China bill or something which could in some way make China get their currency in line with where it should be would go a long way to doing that.

I am originally from New York City so this is a little painful for me to say, but last week the Yankees lost the World Series. They lost the World Series to the Florida Marlins despite a three to one disadvantage in their payroll. I think the way they did that was it was nine players to a side and three outs to an inning, and that is all we are asking for from you. If you can help us, I think we would all appreciate it. Thank you very much for your time and consideration this morning.

[The prepared statement of Mr. Somple follows:]

Statement of Jeff Somple, President, Mack Northern Operations, Mack Molding Company, Arlington, Vermont

Mack Molding Company was founded in Wayne, NJ in 1920, and moved to Vermont in 1939. One of the pioneers in the plastics industry, Mack produces injection molded parts and assemblies for a variety of markets. Mack consists of three main operating divisions—Mack Northern Operations (headquartered in Arlington, VT), Mack Southern Operations (headquartered in Inman, SC) and Mack Technologies (headquartered in Westford, MA). I am the President of Mack Northern Operations and joined the company in 1988.

Over the last fifteen years we have faced, along with most of American manufacturing, numerous challenges. In the 80s and early 90s we were told that we could not compete with the quality of Japanese imports. We invested heavily in people, systems and equipment and were one of the first U.S. companies to achieve ISO registration of our quality system in 1992. We have won numerous awards for our quality performance and were part of the "Quality Revolution" that transformed U.S. manufacturing and allowed us to not only compete but thrive in the new global economy.

Then came the advent of "One Stop Shopping". Our customers wanted to simplify their supply chain and looked for companies that were vertically integrated and had multiple capabilities. Mack added sheet-metal fabrication and contract manufacturing services that included printed circuit board (PCB) assembly and test. We acquired existing companies and continued to add jobs and grow. As the marketplace demanded up-front services to improve "Time to Market" we responded by adding design and prototyping services, creating Mack Design and Mack Prototype.

When our customers demanded "Just in Time Delivery" we developed a network of warehouse and distribution centers throughout the U.S. and Europe, which enabled us to provide multiple daily deliveries while continuing to manufacture in the Eastern United States. The game was constantly changing and we adapted to these changes. We re-invested substantially all of our profits into new facilities, equipment and employee training and development. We were creative, energetic and hardworking—words that also apply to the American workforce and American manufacturers.

Throughout these last fifteen years there has always been the pressure to be globally competitive and to be constantly lowering our cost structure. We have done this as well. We have automated, we have invested in the newest technologies and equipment and we have concentrated on products and markets that have relatively low labor content. Despite competition from countries that have labor rates of $.20/hour Mack continued to be successful. In 2000 we had over 2100 employees and sales in excess of $400 million. Our primary market was Computer & Business Equipment. We provided parts, assemblies and complete products for Fortune 500 manufacturers. These products included high-end servers, storage systems, printers and copiers.

Small electronic devices such as cell-phones, personal CD players and laptop computers had long since left the U.S. and were being manufactured in low-cost countries such as Korea, Mexico and China. This made sense—as a proportion of total cost labor makes up a significant percentage. A $30 electronic toy might have $5 worth of labor. In China, this might be $.50. This difference of $4.50 would represent a 15% savings in the overall cost. Small parts are also easy and inexpensive to ship, so freight was not a major deterrent to this type of work moving offshore. So we concentrated on large, complicated products that had relatively low labor content and required a high level of engineering support. A $10,000 server might have $200 worth of U.S. labor content. In China, this would be $20. This $180 savings sounds significant, but represents only 1.8% of the total cost. Shipping large parts is expensive, and it is also slow and creates a large inventory "bubble" that customers like to avoid. We can compete with these types of products, and over the years were very successful based on a strategy of supporting the high-end of the high technology market.

In 2000 several events conspired to wreak havoc on the computer industry. Y2K created a build-up of infrastructure that was unsustainable and resulted in an industry-wide glut of inventory and capacity. The Internet Bubble burst, compounding the problem. And our three largest customers essentially abandoned their U.S. factories and set up shop in China. We were stunned and confused. Our carefully developed strategy of avoiding the types of products that were likely to move out of the U.S. wasn't working anymore. What happened? Large, bulky, high tech products with low labor content were supposed to be invulnerable to the threat of low cost Chinese manufacturing. In theory they still are.

I do not pretend to be an economist, and I certainly can offer no credentials as a global currency expert. But if what I read is true—that the Chinese yuan is undervalued by 15–40%, then this offers an explanation for the incredible migration of products we are seeing moving to China. Even at the low end of that estimate (15%), that $10,000 server is now $8500. We cannot compete with that. We should not have to compete with that.

Today Mack employs only 1100 people, and are sales are half of their 2000 level. The jobs lost are good jobs, with full healthcare and retirement benefits. In Vermont, these displaced workers have either found work in the service sector, with lower wages and few if any benefits, or they are still looking for work. Every week I hear about additional New England manufacturing jobs lost to China. These include a variety of companies that produce such diverse products as furniture, lawn and garden equipment and sports equipment.

American manufacturing is not afraid of competition. There always has been and always will be lower cost countries. We are not opposed to free trade. In fact, we encourage it. We are not asking for tax relief. We are not asking for tariffs or trade barriers. All we are asking for is a level playing field, where the same rules apply for all participants. Currencies must be allowed to float. It is one of the levelers of the playing field. If a country's exports and trade surplus continue to grow, eventually their currency gets stronger and acts as a natural brake on the outflow of products. This is not being allowed to happen, and we are being asked to play a game we simply cannot win.

Why doesn't Mack simply go to China, like many other U.S. manufacturing companies? There are a couple of reasons, the most important being our sense of community and loyalty to our people and the towns in which we work and live. We have been putting down roots for over 80 years. We have faced every challenge the "global economy" has thrown at us and we have persevered. We have invested in our people, our plants and our equipment to be a world-class supplier to some of America's finest companies. We are an American manufacturer based in a small town in New England. We're proud of our past and believe it or not, confident in our future. We have re-focused on new markets and products that we feel will stay in the U.S. We are now manufacturing medical devices and instruments, office furniture and shower bases. The first question we ask ourselves about a potential new customer is "Will they still be in the U.S. five years from now?" If the answer is no we keep looking. I hope that we will still be asking that question five years from now.

You will be amazed at the things that the American manufacturing sector can accomplish if we are simply allowed to compete. If the same rules apply to all the players, we always have and always will find a way to win the game. Last week the Florida Marlins defeated the New York Yankees despite a 3 to 1 disadvantage in payroll. How? 9 players to a side, 3 outs to an inning. That's all we're asking.

Thank you for your time and consideration.

Mr. PORTMAN. Thank you, Mr. Somple. That was a good analogy. Mr. Houghton probably was not appreciative of being reminded of that, being from New York, but I appreciate that. Mr. Trumka, welcome.

STATEMENT OF RICHARD M. TRUMKA, SECRETARY-TREASURER, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. TRUMKA. Thank you, Mr. Chairman, Members of the Committee. I thank you for the opportunity to testify today on the U.S.-China economic relationship on behalf of the 13 million men and women of the AFL–CIO, and I particularly want to thank you for allowing me to be associated with this panel.

Addressing the problems in the U.S. economic relationship with China is of enormous importance to our members. The U.S. bilateral trade deficit with China hit $103 billion last year, and the U.S. trade deficit with China is up another 22 percent in the first 8 months of this year compared to the same period last year. Our imports from China continue to outstrip our exports by more than 5 to 1, making this by far our most imbalanced trade relationship with any major trading partner.

Meanwhile, the United States has lost more than 2.5 million manufacturing jobs since March 2001. While many factors contributed to this devastating job loss, it is clear that the Chinese Government's manipulation of its currency, violation of international trade rules, and egregious repression of citizens' fundamental democratic and human rights are key factors to an ongoing unfair competitive advantage. The Chinese Government is flouting its international obligations, and the Federal Government must act urgently to hold it accountable.

Unfortunately, to date our government has failed to effectively stem the job losses resulting from the growing U.S. trade deficit with China. The Bush administration has refused to take concrete steps to ensure that the Chinese Government live up to its international obligations on trade, on currency manipulation, human rights, and has denied American businesses and workers import relief that they are entitled to under the law and, quite frankly, has taken positions at the WTO that would only worsen our relationship with China.

As you may know, the Washington Post reported on Wednesday that the Chinese Government promised to purchase additional U.S. products, including planes, jet engines, and auto parts. This may do little to correct the enormous trade imbalances. China made similar promises prior to its accession to the WTO in 2001, but has largely ignored these commitments. A few new purchases are no substitute for real compliance with its trade obligations.

Over the past 2 years, China has repeatedly and consistently failed to comply with WTO rules. The Administration rather than take advantage of the WTO's formal dispute settlement mechanism to address these violations has preferred to rely on prolonged discussions and informal consultation in its attempts, failed attempts, to guarantee China's compliance. The United States has yet to launch one formal WTO complaint against China for all these violations. China on the other hand has joined in the WTO challenge to the U.S. steel safeguard and has increased its use of antidumping actions against the United States.

The Bush administration has also failed to take or make the TRM, established in China's accession agreement, an effective means of monitoring China's compliance with its WTO commitments. China has kept its currency, the yuan, pegged to the dollar at the same rate since 1994, and it is estimated to be undervalued by as much as 40 percent. This gives China an enormous competitive advantage, as the three people on the panel just testified, and creates an inherently unstable and unsustainable situation.

The Chinese Government must allow the yuan to reflect underlying economic and market forces. It must end the current pay, and while the Chinese Government is reluctant to take this action is perhaps understandable our own government's failure to act more forcefully regrettably is not understandable to us. We call on the Administration to use all tools at its disposal, including initiating a WTO case, to send a clear message to the Chinese Government that the current situation is unacceptable and will not be tolerated.

The Fair Currency Alliance, which we are a part of, will soon file a case against China for currency manipulation under section 301 of the U.S. trade law, the section that protects us against unfair trade practices by other countries. Mr. Chairman, if I might continue for just a minute on human rights. Thank you, sir.

In addition to the unfair competitive advantage gained through currency manipulation, the Chinese Government's systematic repression of fundamental workers rights is a key contributor to the unfair advantage that Chinese exports enjoy in the U.S. market. Chinese workers' most basic rights are routinely repressed and they do not enjoy the political freedom to criticize, let alone change their government. Enforcement of wages, hours and health and safety rules is lax or nonexistent in many areas of the country. These abuses allow producers in China to operate in an environment free of independent unions to pay illegally low wages and to profit from the widespread violation of workers' basic human rights.

I want to give you one classic example that I am familiar with. Chinese mine workers face conditions that surpass the absolute worst labor abuses that our country ever envisioned and endured. Research indicates that more than 10,000 people die in Chinese mines each year. Coal mines in China may be the most dangerous places in the world to work, but unlike American mine workers, Chinese mine workers are denied the right to organize and bargain collectively and are effectively denied any real meaningful health and safety regulations. Those policies amount to a deliberate and artificial suppression of wages, and the exploitation impacts American workers as well as those of other developing countries and artificially lowers the price of Chinese exports in the U.S. markets.

Mr. Chairman, we have ample opportunities to address those issues. The Bush administration chose not to even raise the case of China before the U.N. Human Rights Commission in April 2003 despite the fact that the United States had regularly raised that issue before.

We really believe that something needs to be done and done quickly to help American workers and the American economy, and once again let me thank you for allowing me to be here and testify today, but also let me thank you for being associated with the rest of the panel.

[The prepared statement of Mr. Trumka follows:]

Statement of Richard M. Trumka, Secretary-Treasurer, American Federation of Labor and Congress of Industrial Organizations

Mr. Chairman, Members of the Committee, I thank you for the opportunity to testify today on the U.S.-China economic relationship on behalf of the thirteen million working men and women of the AFL–CIO. As you know, addressing the problems in the U.S. economic relationship with China is of enormous importance to our members.

The U.S. bilateral trade deficit with China hit $103 billion last year, up almost 25 percent since China was granted Permanent Normal Trade Relations status in 2000. The U.S. deficit with China is up another 22 percent in the first eight months of this year compared to the same period last year. Our imports from China continue to outstrip our exports by more than five to one, making this by far our most imbalanced trade relationship with any major trading partner. Meanwhile, the United States has lost more than 2.5 million manufacturing jobs since March 2001.

While many factors contributed to this devastating job loss, it is clear that the Chinese Government's manipulation of its currency, violation of international trade rules, and egregious repression of its citizens' fundamental democratic and human rights are key contributors to an unfair competitive advantage. The Chinese Government is flouting its international obligations, and the U.S. government must act urgently to hold it accountable.

Unfortunately, to date, the U.S. government has failed to act effectively to stem the job losses resulting from the burgeoning U.S. trade deficit with China. The Bush Administration has refused to take concrete steps to ensure that the Chinese Government live up to its international obligations on trade, currency manipulation and human rights, has denied American businesses and workers import relief they are entitled to under the law, and has taken positions at the World Trade Organization (WTO) that will only worsen our trade relationship with China.

As you may know, the *Washington Post* reported on Wednesday that the Chinese Government promised to purchase additional U.S. products, including airplanes, jet engines, and auto parts. However, this may do little to correct the enormous trade imbalance. China made similar promises prior to its accession to the World Trade Organization in 2001 but has largely ignored those commitments.

Violations of WTO Rules Continue

Over the past two years, China has repeatedly and consistently failed to comply with WTO rules. The Bush Administration, rather than take advantage of the WTO's formal dispute settlement mechanism to address these violations, has preferred to rely on prolonged discussions and informal consultations in its failed attempts to guarantee China's compliance. The U.S. has yet to launch one formal WTO complaint against China for all of these violations. China, on the other hand, has joined in the WTO challenge to the U.S. steel safeguard and has increased its use of anti-dumping actions against the United States.

The Bush Administration has also failed to make the transitional review mechanism (TRM)—established in China's accession agreement—an effective means of monitoring China's compliance with its WTO commitments.

Failure to Act on Currency Manipulation

China has kept its currency—the yuan—pegged to the dollar at the same rate since 1994, and it is estimated to be undervalued by as much as 40 percent. This gives China an enormous competitive advantage in the U.S. market and creates an inherently unstable and unsustainable situation.

WTO rules clearly prohibit currency manipulation to gain trade advantages inconsistent with GATT provisions. Article XV of GATT 1994, for example, provides that "Contracting parties shall not, *by exchange action*, frustrate the intent of provisions of this agreement" (emphasis added). Currency manipulation nullifies tariff concessions made through WTO processes and amounts to a de facto illegal subsidy of Chinese exports. Deliberate undervaluation of the yuan vis-à-vis the U.S. dollar also violates the principle of most-favored-nation treatment, as it targets one country's currency, adversely impacting that country's trade. Certainly, the enormous bilateral U.S. trade deficit with China relative to other countries is evidence of the uneven impact of China's currency policies on its trading partners. China's choice to artificially bolster its own manufacturing sector at the expense of the United States (and other countries indirectly) is therefore a violation of its obligations under the WTO.

The Chinese Government must allow the yuan to reflect underlying economic and market forces. It must end the current peg and cease its accumulation of U.S. dollar reserves. While the Chinese Government's reluctance to take this action is perhaps understandable, the Bush Administration's failure to act more forcefully in this regard is not.

We call on the Administration to use all tools at its disposal, including initiating a WTO case, to send a clear message to the Chinese Government that the current situation is unacceptable and will not be tolerated. It is now clear that simple diplomacy and jawboning have utterly failed. The AFL–CIO has joined a coalition of labor and business to call on the Bush Administration to insist that the Chinese Government end its destructive manipulation of currency, or face trade sanctions. The Fair Currency Alliance will soon file a case against China for currency manipulation under section 301 of U.S. trade law—the section that protects against unfair trade practices by other countries.

Inaction in the Face of Violations of Workers' and Human Rights

In addition to the unfair competitive advantage gained through currency manipulation, the Chinese Government's systematic repression of fundamental workers' rights is a key contributor to the unfair advantage Chinese exports enjoy in the U.S. market. Chinese workers' most basic rights are routinely repressed, and they do not enjoy the political freedom to criticize, let alone change, their government.

The Congressional-Executive Commission on China released its 2003 annual report a few weeks ago. The Commission concluded that: "Chinese citizens are detained and imprisoned for peacefully exercising their rights to freedom of expression, association, and belief. . . . Chinese workers cannot form or join independent trade unions, and workers who seek redress for wrongs committed by their employers often face harassment and criminal charges. Moreover, child labor continues to be a problem in some sectors of the economy, and forced labor by prisoners is common." In addition, the Commission found that people seeking to practice their faith were subject to harassment and repression, while freedom of speech and freedom of the press were denied.

Enforcement of wages, hours, and health and safety rules is lax or non-existent in many areas of the country. These abuses allow producers in China to operate in an environment free of independent unions, to pay illegally low wages, and to profit from the widespread violation of workers' basic human rights. For example, Chinese mineworkers face conditions that rival some of the worst American labor abuses in American history. Research indicates that more than 10,000 people die in Chinese mines each year. Coalmines in China may be the most dangerous places in the world to work.

Chinese policies amount to a deliberate and artificial suppression of wages. This exploitation impacts American workers, as well as those in other developing countries, and artificially lowers the price of Chinese exports in the U.S. market.

During 2001 and 2002, the number of labor disputes and protests in China rose significantly. In response, the Chinese Government jailed a number of workers for demonstrating for their rights and cracked down on any organization that might support the beginnings of an independent trade union. The official labor union—the All China Federation of Trade Unions (ACFTU), which is subordinate to the Communist Party—continued to discourage strikes and work stoppages, and to negotiate sweetheart deals with employers.

In the face of these grave problems, the Bush Administration chose not even to raise the case of China before the UN Human Rights Commission in April of 2003, despite the United States' regular practice of doing so previously. In addition, President Bush did not demand any specific improvements in human rights when he met with China's President Hu in the summer of 2003. Instead, the Bush Administration has only engaged in "cooperative dialogueue," a strategy that has not worked. Since deciding to pursue a dialogueue instead of UN action or public pressure, Administration officials have noted "backsliding" and a "deterioration in human rights" in the country during 2003, including arrests of democracy activists, harsh sentences for labor organizers, and the suppression of independent media, church groups, and Tibetans.

The Administration's failure to take concrete actions on human rights and workers' rights in China allows rampant violations to continue. Workers in China, the United States, and around the world pay the price for this inaction, while companies producing in China enjoy the profits.

In addition to inaction on China's currency manipulation and workers' rights violations, the Bush Administration has failed to enforce U.S. trade laws effectively with respect to China, denying American businesses and workers the trade relief they are entitled to under the law. Despite the fact that the International Trade Commission (ITC) found that several U.S. industries have been harmed—including pedestal actuators and wire hangers.

President Bush's repeated refusal to act on the ITC's recommendations left domestic manufacturers questioning the Administration's willingness to ever use the special safeguard mechanism. In both cases, the ITC evaluated all of the facts from both sides in finding that safeguard action was called for, and in both cases President Bush made a political decision to dismiss the findings and deny import relief.

Another special safeguard mechanism created in China's WTO accession agreement with the U.S. deals exclusively with textiles. In July of this year, a group of textile industry associations filed petitions under the provision, seeking the re-imposition of import quotas on brassieres, gloves, gowns, and knit fabric from China. In each category, imports from China have jumped sharply after the elimination of quotas—for example, dressing gown imports rose 698 percent in the 15 months since quota elimination, and glove imports jumped 291 percent during the same period. Yet the Commerce Department has already rejected the industry petition on gloves, and importers are urging that relief be denied in the other product categories as well.

Inadequate Protection from Dumping

One provision of our domestic trade law that U.S. companies have been able to use to secure some limited relief from unfair trade practices by China is in the area of anti-dumping. But much more could be done. Though the United States absorbs almost half of all of China's exports to the world, we account for only 15 percent of the anti-dumping measures imposed against China, according to the WTO. In addition, in many cases the duties imposed under U.S. anti-dumping measures regarding China have been inadequate to provide real relief to U.S. companies.

In each of these cases, the Bush Administration had the opportunity to effectively enforce U.S. trade laws, but chose not to do so, choosing to side with the importers and the Chinese Government, at the expense of American workers and producers.

Conclusion

Rifts within the business community have contributed to the U.S. government's passivity and failure to act to date. Companies that produce in China for the U.S. market, retailers, and importers clearly benefit from an undervalued Chinese currency, as well as from the abuse of workers' rights. On the other hand, companies actually producing in the United States—whether for the domestic market or for export—face debilitating and unsustainable disadvantages from currency manipulation, illegal subsidies and dumping, and violation of workers' rights in China.

American policymakers have a choice to make in trade relations with China. They can side with the importers and outsourcers, and stand by passively as China takes advantage of its WTO membership and access to the U.S. market, abusing its own workers and artificially undervaluing its currency in order to undercut American workers and domestic manufacturers. Or they can take a stand for American jobs and act now to ensure that China plays fair in the global economy.

Thank you for your attention and for the invitation to appear here today. I look forward to your questions.

Mr. PORTMAN. Thank you, Mr. Trumka. I appreciate the panel's testimony. We will start our questioning with Mr. Crane, Chairman of the Subcommittee on Trade.

Mr. CRANE. Thank you, Mr. Chairman, and I want to thank our witnesses for appearing here today. Mr. Trumka, you have suggested that China maintains a policy of deliberate currency devaluation in order to make its exports competitive. What explains then the fact that China has maintained the same peg of its yuan to the dollar for over 10 years and that China's worldwide trade surplus is fairly small?

Mr. TRUMKA. The fact that it floats with our currency no matter where our currency goes. I think all economists and all the evidence indicates that they are in fact pegging their currency to U.S. dollars, and I believe the case is irrefutable.

Mr. CRANE. Well, then in effect you are saying we are the ones that are guilty, we are inflating our currency?

Mr. TRUMKA. We are guilty for not challenging it.

Mr. CRANE. No. We are guilty of inflating our currency and theirs remains the same relationship with ours.

Mr. TRUMKA. No. The guilt is if you look at all the economic factors, their currency should have risen in the market but it hasn't. It has maintained the same peg to ours. When our currency goes up, theirs go up. When ours go down, contrary to all economic indicators, theirs goes down too.

Mr. CRANE. Theirs goes down too because it is pegged to ours?

Mr. TRUMKA. Correct.

Mr. CRANE. If China were manipulating its currency for trade advantage, why wouldn't it allow the currency to fall further in order to develop a larger trade surplus?

Mr. TRUMKA. Because that would ultimately hurt them as well. They like a 40-percent advantage. I think as these gentlemen just told you, with a 40-percent advantage they feel very comfortable being able to take over significant markets, particularly those here in the United States.

Mr. CRANE. The next question is for the panel, anyone who wishes to respond. Earlier witnesses have testified that changing the exchange rate of the Chinese yuan will have a marginal effect on the price of Chinese exports to the United States because China adds relatively little value as an assembler or finisher of components imported from elsewhere. Do you folks have any response to these or other witnesses?

Mr. HEAD. I would say that I do not agree with that. I think that when a currency appreciates, it makes the countries goods more expensive. You would look at that in the case of Europe. The goods coming from Europe today are more expensive than they were a year ago because the Euro has appreciated by 20 percent and that makes their goods 20 percent more expensive. The Chinese yuan has stayed depressed because they purchase $600 million a day to keep it pegged to the dollar. That is currency intervention, and it keeps their currency depressed. They have to do that. That was reported in the Financial Times, and it is just an example of currency manipulation.

I think that the example of Japan has been misused as well. Japan followed the same course of having dramatically undervalued currencies up until 1985. What you see is that they had dramatically overbuilt capacity and that during the next 10 years their stock market didn't appreciate as they tried to siphon off the excess capacity that they built during the years that they had an undervalued currency.

So, I would say no, I don't agree. I think that an undervalued currency makes Chinese goods significantly more competitive in American markets, and that is the reason they are doing it.

Mr. CRANE. Do you think we have an undervalued currency?

Mr. HEAD. Our currency has dropped against the Euro and the yen, and I think that is appropriate given the trade deficit that we have had. The trade deficit I do think takes away manufacturing jobs across the spectrum, and the falling of the dollar I think is appropriate and I think the policy of allowing the dollar to fall, moving away from strong dollar policy is a very good idea.

Mr. CRANE. Mr. Trumka.

Mr. TRUMKA. Thank you, Representative Crane. I would also like to add that our trading relationship with China is relatively in its nascent stages and one thing that must be established is the rules that we will continuously trade by. Pegging currency violates those rules. Not living up to the accession agreement violates those rules, and if we don't establish real rules at the beginning of this relationship, we fear that they will never be established given the traditions of the Chinese people.

Mr. CRANE. Well, except can't we continue to engage in the same thing the Chinese are doing then? When I first came to Congress here, our dollar was worth 10 times what it is worth today. The dollar today is only worth 10 cents of what the dollar was worth back in 1970, and we continue that. Comments from anyone?

Mr. HEAD. I would say that our dollar is determined by market forces. We allow our dollar to float. It is determined by economic principles, and those economic principles have brought the dollar to where it is today. When we abandoned the gold standard, which was a reasonably good standard, we went to a system of floating rates so that economic forces would determine currencies. To have a fixed rate within a generally floating rate economy or global economy is a—in order to maintain it, you have to intervene to keep it there. We do not intervene to keep our currency either low or high, and so I would say that it floats to the level that it should be.

Mr. CRANE. I remember when you could buy an ounce of gold for $20 and today it is $385.

Mr. HEAD. I think that the reduction of the value of the dollar has been influenced by economic forces that bring global trade into balance and when you intervene in that system, it takes it into imbalance.

Mr. CRANE. It is also an advantage for the government to pay off its debts. Thank you. I yield back the balance.

Mr. PORTMAN. Thank you, Mr. Crane. Ranking Member this morning, Ms. Tubbs Jones.

Ms. TUBBS JONES. I love the way that sounds. Don't tell Mr. Rangel I said that. I will wait my turn, Mr. Rangel. Good morning, and thank you very much for coming here to testify this morning. I don't think I could say any better what I was trying to say on the first panel than what you all have said this morning, and each of you represent what I have been hearing from the businesses in my Congressional District that are not the multi-national businesses, that you all are struggling and you want help and you want encouragement, and I just want to commit that I am here to do what I can. If there are some issues that you would like to bring to my attention, please feel free to do so. I would really like to allocate my time to allow you to say whatever else you want to say versus asking you questions, and I guess I have 5 minutes. So, each of you can get a minute and a quarter. I do want to encourage you to continue to speak out and get your colleagues to speak out because it is a voice that must be heard on Capitol Hill from the small businesses who are struggling to stay afloat throughout our Nation, and I salute you for the work that you are doing. I am going to do all I can to be supportive. The AFL–CIO, keep on working. Mr. Galbraith, we will start with you, and we can just go down the line. You can say what you want to say, gentlemen.

Mr. GALBRAITH. Well, I think it is important that we understand that we—the earlier panel talked about middle class. Middle class is what has been the economic driving force of this country and if we destroy the manufacturing jobs of this country we are in essence destroying our middle class, which removes our buying power, and I again think why are we so interested in raising other people's standard of living while we are lowering our standard of living in this country? Thank you.

Mr. HEAD. I guess I would just comment that I believe that the situation is going to get worse. It is not slowing down. It is accelerating. I think the infrastructure that is in place to transfer U.S. jobs to China is growing more and more. I get calls from consultants that tell me they can take my business over to China. So, I see this problem getting worse and worse, and I think that the strength that we are seeing in the economy is somewhat illusory because it is great for people to go out and spend a lot of money, particularly on cheap stuff, but if our productive sector is being eroded, I think that is going to be a problem and I think it is going to make it hard for us to sustain an economic recovery. Thank you.

Mr. SOMPLE. I think the first panel was indicating that the backbone of the American economy is the small and medium sized businesses, which is what we really represent, and I think we are the ones that have really been suffering the most over the last few years. It is not just us, it is our sub-tier suppliers, the people who make the tools and the dies.

Someone referenced earlier that the Economic Reform Act, someone was going to buy a tool. Well, if they go buy that tool they will probably be buying it in China right now, unfortunately. I have about 200 tools under construction for various customers, and I am proud to say every one of them is under construction in the United States. That gets more and more difficult to do when we see some of the pricing that has been thrown out by these people. Again all I want to do is reiterate that at least from my point of view, and I think the people here share some of those thoughts, we are not here looking for tax breaks. We are not looking for any sort of restrictions. We are not looking for special deals. All we are looking for is make everyone play the game by the same rules, and if you do that American manufacturing will figure out a way to win the game. We always have in the past, but in this case the odds are just a little overwhelming. Thank you.

Mr. TRUMKA. Thank you. The first thing I would do is point out to the Committee's attention; that is, the Congressional Executive Commission on China released its 2003 annual report just a few weeks ago. I would urge you to include that in the record because of the significant findings that it has about not only human rights and labor rights and health and safety rights but also a multitude of other things that the Chinese Government is doing with the lack of enforcement of wages and health care rules and safety rules. In addition to that, I was—we were very disappointed that yesterday the government, the Administration, certified China as not manipulating its currency, and I have to tell you that certification yesterday by the Secretary in our opinion both defies logic and defies the record, and it sends completely the wrong message to China.

Ms. TUBBS JONES. Mr. Trumka, if you get a copy of that or if I can get a copy, I will seek unanimous consent to have it submitted to the record. I would just reiterate something that was said earlier today. I joined my colleague Mr. English in his motion on the floor the other night with regard to the China currency, and hopefully in a bipartisan way we will be able to continue to press this issue. I thank the Chairman for the opportunity to address you. Again, gentlemen, thank you so much for appearing here this morning.

Mr. PORTMAN. The gentlewoman from Ohio has made a unanimous consent request that we include in the record of this hearing the Commission's report and, without objection, it will be in the record. The gentleman from New York, Mr. Houghton.

[The information is being retained in the Committee files.]

Mr. HOUGHTON. Thanks very much. This is a fascinating issue because it gets to our gut. It gets to the livelihood of millions of people, and the thing I am trying to do is to get over the hurdle rather than beating the horror stories and what do we do? It is very easy to say make everybody play by the same rules, but that is not easy. What are we going to do in Brazil about the environment? What are we going to do in China about child labor? Do we have control over that? I don't know that we do. We would like to. We would like to set the standards, we would like to have fair labor rates, we would like to have fair environmental standards, but it is hard getting inside a country to do that now.

You can say, okay, so if you don't play by the rules that we set, then you can't trade with us. Well, that is one way of doing it, and what that does is it puts a wall around our country, and some of our European and Latin American and Asian competitors would love that because they can go in and exploit the market the way they want.

So, the question is what do we really have control over? When you enter the world, and not by royalty agreements or just by exporting but by really reaching into countries to try to sell your product, then you have got to expect those people will come back into our country. The government doesn't export jobs. We don't have any jobs to export. It is private industry that is doing that. The people that you compete with, the people that are your suppliers, the people that are your customers, they are doing this. So, what do you say to the XYZ company and say you just don't do that because you are not playing by the same rules? That is tough. We can help on tax policy, and you can help in terms of quality and service and fast response and ideas and good technical ideas, but that really isn't going to be enough. If we go the section 201 and the section 301 route, that is a long time. I have been down that road, and that takes a long, long, long time. We are dying now. So, what are those things practically which are under our control that we can do to impact this whole situation? It really requires immediate action. I open that for an answer.

Mr. SOMPLE. I think the panel this morning talked about a lot of issues, and you just brought up a lot of issues and we got into the Brazilian rainforest somehow. I really think just to try to simplify things, I think what you have heard has kind of been unanimous today, at least from this panel, is what you can do is sponsor a bill similar to the China bill, which is dealing with one specific issue which everyone agrees is one of the largest ones we are facing and basically tie some sort of punishment or whatever for them not abiding by their agreed-to WTO agreement to allow their currency to float. They are not doing that. Again, I am not a global economist, but I can read the USA Today and today in my hotel room was slid this, and I looked at foreign currency per dollar, and it has Thursday, Wednesday, 6 months ago, and a year, every major currency in the world. Every one, the numbers change. The China yuan 8.2781, Thursday, Wednesday, 6 months ago, and a year ago. If you can do one thing, change that. Thank you.

Mr. HOUGHTON. Fine. So, we change it. So, how does that affect somebody who competes with you? What do they do? Do they stop dealing with China? If they do, do they go to Malaysia, do they go to Singapore? How do we stop the overall erosion?

Mr. TRUMKA. I think, first of all, there is no magic wand that you wave at this thing. I think it is several things that you have to do in tandem with one another. I think currency manipulation is obviously one very important thing. I think you also look at tax code and begin to reward manufacturers that produce here as opposed to rewarding people who take those jobs and go offshore. I think you also begin to enforce and demand enforcement of the trade laws that we have agreed to. It is not about whether we trade or not. It is about the rules that are in place when we trade. China has agreed to a set of rules, and they are not living by them.

The USITC has found on several occasions, one in textiles, one with pedestal actuators, another one with metal hangers, that China was violating the trade laws. Our government refused to enforce those. It is more than just jawboning. You have to actively enforce it and you have to be serious about it. You have to tell them that the rules are the rules and everybody must play by them and establish that from day one. We have not done that. We wink at them. We pretend that they are rules, they violate the rules, and we continue winking at them. We lose when that happens. It is up to this esteemed body and the Congress in general to scrutinize trade bills as they come up and make sure that they are a good negotiated deal, that they are good to our country as they are to our trading partners.

No one wants to say build a wall around the United States. What we want to say is establish rules that are fair to us and make sure that the rules are adhered to. It is like playing a football game——

Mr. HOUGHTON. Just a minute longer, if I could. If you want to make sure the rules are adhered to, what club do you have?

Mr. TRUMKA. Well, unfortunately with some of the trade agreements that we have already done, few. We still have antidumping laws. We still have the ability to persuade and demand things.

Mr. HOUGHTON. Many of these things fall outside the dumping category?

Mr. TRUMKA. Sure they do.

Mr. HOUGHTON. For example, if you had very, very low wages it can be entirely legal outside the section 201 or section 301 issues. How do we get at that?

Mr. TRUMKA. Here is an example. A number of manufacturers filed a complaint with pedestal actuators, saying that China was illegally dumping—violating the trade rules, not just dumping but violating the trade rules. The USITC ruled unanimously. Our government then said unilaterally that it is not in our economic interest to enforce that agreement. Now, when you tell people you have rules, you don't enforce them, they will continue to violate them and we will continue to be put at a disadvantage.

Again there is no magic wand that you can wave and make it go away. It takes a series of actions and it takes all of us working together to do that, working together, labor and management, to make more effective products, working together with both sides of the aisle to get better trade deals and to make sure that they are enforced.

Mr. HOUGHTON. I would agree with that. Thanks very much. Thanks, Mr. Chairman.

Mr. PORTMAN. Thanks, Mr. Houghton. Mr. Collins from Georgia.

Mr. COLLINS. Thank you, Mr. Chairman. It is good to have a panel that all agree on a couple of things. No diversity on this one, except maybe in the area of those who actually run manufacturing and those who are actually part of labor, but they are still all the same.

We all agree that we have heard testimony that the VAT in China has been misused through trade subsidies for Chinese companies. We have all heard about the currency and we all agree there are some problems in this area of currency. You made a very good example when you talked about the levels of the—the current value of the currency in China and how it has not changed month to month, day to day or year to year. This is all about competition, competition in the marketplace, but it is also about competition among workforces competing with other workforces in other nations. What are some of your employees, what are they telling you about how they perceive this situation?

I believe it was you, Mr. Head, who said people understand. What are your employees telling you? What are they relating to you?

Mr. HEAD. I would say that I think employees—this is a very frightening situation for employees and I think that they are very appreciative of the companies that are willing to stay loyal to them. I am saying there is a lot of companies that are willing to sell out employees and move to China for the subsidies that are offered and I think that we need to support the employers that are——

Mr. COLLINS. That is what you think, and I don't have any problem with your thoughts, but what are your employees telling you? What are they telling you, Mr. Galbraith?

Mr. GALBRAITH. Congressman, what our employees are telling us, I think for the first time the employees are saying someone is speaking up for me and what we keep telling them is that our leaders in Washington are concerned about their future and things will be done and that the WTO has some safeguards in there that says if you disrupt certain industries that certain things will be done. I know that each of you probably have been bombarded by e-mail from different textile employees in particular and we keep telling—even though they incur lost wages due to working short time, those are being laid off, but they are depending upon this government to give them an opportunity to compete fairly because wages are not the issue. I think every one of these gentlemen on this panel will say on wages we can compete with anyone in the world because our productivity is probably higher than anyone in the world. We have innovations and creativity that other nations don't have.

Mr. COLLINS. How about Mack Molding?

Mr. SOMPLE. Basically I would say that my workers are scared and they don't understand what is going on, and as we have had kind of an ongoing dialogue trying to educate people, I think there has been some anger, and the basic feeling comes down to one of that it is not fair and why isn't someone doing something about this? I would also agree that over the past several months I have been somewhat encouraged, and I have shared that with our workforce, that it sounds like the issue is actually being addressed and recognized and that maybe something good is going to come out of it.

Basically the American manufacturing worker today is fearful for their job, they are fearful for their future, they are fearful for their 401(k) and everything that goes with that. I can't just go in and say, don't worry, things are going to be fine, because I don't know if they are going to be.

Mr. COLLINS. A lot of those things you just named are non-production costs, they are benefits?

Mr. SOMPLE. Absolutely.

Mr. COLLINS. Benefits are something that you choose based on what we put forth as rules and law, but what are you telling them about other costs; that is, nonproductive costs such as taxes, such as regulations, such as the cost of protection in possible litigation cases, what are you telling your employees?

Mr. SOMPLE. Well, we certainly don't want to be telling our employees that we are going to be trying to take our non-production costs down to the levels of other countries. They are aware that things like that make it more difficult to do business in the United States. Specifically, in my home State of Vermont it is even on the other extreme in terms of some of the environmental and some of the regulatory laws. If you want to try to build a new factory, good luck. By the time you figure out the paperwork, you have retired. So, I think our workers are aware that part of the—I don't want to call it the problem. Part of the thing that makes it a little more difficult to be competitive is the fact that we offer a lot of these benefits, and we want to continue to do that. We don't want to cheapen down our jobs as a way to compete. We want to get better at what we do, and we want to make investments where appropriate, whether it is in people and training or whether it is in equipment or facilities or technology, to try to be able to compete without eroding the benefit package.

We have already done some things to our benefit package where our benefits basically aren't as good as they used to be a few years ago, particularly in the area of health care. We have higher deductibles and things like that and our workers understand that. They don't like it, but they understand that is the type of thing that is going on right now.

Mr. COLLINS. Mr. Trumka, you have insisted on forcing people to play by the rules, and I don't think any of us object to the fact that they ought to play by the rules. They should. It is what the rules are made for, because I think Mr. Houghton made a very good point, that unless you have a big club it is very difficult to do so, and we have a big club. We have the market, but you also made a very interesting statement. You said that we need to reward manufacturers through tax codes. What do you mean?

Mr. TRUMKA. I think that those manufacturers, those people that produce things here, if there is going to be rewards through the tax code, through tax deductions, tax credits, those are the ones that receive it. We believe, in our analysis of the tax code right now, that it is the opposite of that. Those that decide to take production facilities and move them offshore get the rewards of the tax code to the greatest extent and those that stay here get penalized for staying here. They get penalized in a number of different ways. They don't get the credits or the deductions that others do for going offshore. They pay increased health costs whenever those costs are socialized or controlled in other areas. They live by regulations that aren't enforced in other countries.

The average manufacturing wage in China is 25 cents an hour. The legal minimum manufacturing wage is $56 a month, and the China Commission that I referred to earlier found out that it is not enforced.

Mr. COLLINS. What I am hearing you say is you don't believe that the corporate tax rate or the tax rate should be reduced for all corporations, whether they be a manufacturing or whether they be a service provider, whether they be a retail or whatever, just those who will stay within the boundaries of the United States and manufacture. Is that what I am hearing you say?

Mr. TRUMKA. I wouldn't be that dogmatic about it. What we are looking to say is take the tax code and remove incentives that encourage and reward people for going offshore. If you are staying here and you are producing your service or you are going to India to send that service back here, I think you ought to be treated differently. I think if you live here and you work here you shouldn't be able to have a mailbox in Bermuda and not pay any taxes here. I think those are all rules that when I talk to workers out there they are confused by that. They think that they are forced to play by a separate set of rules that others aren't playing by, and they think that responsible employers that work with them are being disadvantaged because those rules aren't being enforced and the tax code——

Mr. COLLINS. You made a statement about a mailbox in Bermuda, but those who set up a mailbox in Bermuda leave the jobs here. They still pay tax here.

Mr. TRUMKA. That is not necessarily so.

Mr. COLLINS. I guess you can say it either way, but that was what you were referring to. Many of them do leave their jobs here. I believe, Mr. Somple——

Mr. SOMPLE. I am jumping out of my skin here a little bit simply because I would love to be in the position of worrying about my tax burden again because that means that I am making money, and I think a lot of people in the first panel were very concerned about taxes. There is only one reason for that. I am not worried about taxes. I used to have a tax consultant who would come in every year and help me figure out what I was going to do, and I don't need him anymore. I am just trying to figure out a way to get over the profit line again, and then I can worry about taxes. So, I don't need a tax cut.

Mr. COLLINS. Well, you might not—what was your opinion 12 years ago?

Mr. SOMPLE. I was of a totally different opinion 12 years ago.

Mr. COLLINS. I hope you have a different opinion 5 years from now.

Mr. SOMPLE. So do I. Believe me, right now I would love nothing better than to be paying taxes.

Mr. COLLINS. It is a very difficult situation, but what we need to focus on is the 94 percent of the employed in this country and try to maintain their jobs and, if we do, we will create jobs for the others that want to work. Thank you.

Mr. PORTMAN. Thank you, Mr. Collins. Mr. English from Pennsylvania.

Mr. ENGLISH. Thank you, Mr. Chairman, and I have been very intrigued by the testimony of this panel. I want to say, Mr. Head, that for the editor you talked to who claimed that trade would not be a political issue in this cycle because people don't understand, I think that person should have been in Erie, Pennsylvania on

Labor Day in the middle of our town square when 400 people turned out in the rain to protest against China's predatory trade policies and especially its currency manipulation.

So, from my perspective I think this is a big issue, it is a big concern, and it is a universal concern to people who care about the American economy.

Mr. Somple, I realize you have laid yourself bare by confessing that you are not an economist. Within the Beltway that is a big disadvantage. I have been reading some of the testimony that has been submitted for the record by a couple of prominent inside the Beltway economists. One of them from the Cato Institute made this statement:

> "There has been no wholesale movement of U.S. factories and investment moving across the Pacific to China. If the critics were right, U.S. multinationals would be falling over themselves to relocate capacity to China to take advantage of its low wages. In reality, U.S. investment in China has been stable and modest."

I would like you all to comment on that statement, and then if you wish to, perhaps list the top three things that Congress can do in your view to level the playing field for U.S. manufacturers. Mr. Galbraith.

Mr. GALBRAITH. Well, I think it is very interesting when we say that these jobs have not been displaced. The textile industry has been displaced dramatically by China. You go through China today and you see new textile mills popping up all through China.

To answer your other questions, what can be done, I still can go back to what everyone in this panel has alluded to, and that is the currency manipulation. If the currencies are equal, the Americans can compete with anyone. Our productivity in this country can compete with anyone. Let us get the playing field even. There are safeguard provisions that allow for disrupting industries. Let us look at those safeguards. Let us implement it, and I encourage you to look at it and do it rather rapidly, encourage our President to make this happen because every day that goes by more and more factories are closing in this country. Before I will get home today I just went through all through South America, through Honduras, through Guatemala, looking at partnerships of where we might be able to take more cost out of garments, but when I see job losses in this hemisphere and then I look in Mexico and I visit facilities where their standard of living had come up, granted it has. They have got it up to where they may make $2 an hour, but they are too expensive.

Mr. ENGLISH. Mr. Head.

Mr. HEAD. Yes. I am not sure where the Cato Institute gets that information because I think what we are to understand is that 65 percent of the exports that come out of China are with joint ventures from Western companies where the investment has gone into China. They have become the number one recipient of foreign direct investment. From my personal experience we have seen it in our customer base as well as our supply base, people moving to China. It has affected our business dramatically, and I would answer your question about what we should do by agreeing with these gentlemen that the currency manipulation is probably the biggest thing and that we should be taking aggressive action on it and in terms of the kind of club that can be used to do that, I would agree that the China bill is a very good one, not the answer, not the right answer, but potentially the type of policy motivation that can move the Chinese toward playing fair in the marketplace.

Mr. ENGLISH. I take your point, and I thank you for your compliment. Mr. Somple.

Mr. SOMPLE. One thing that may have happened with the multinationals not appearing to be flocking to China as fast as one might think, according to that report, there is a phenomenon that happened in the late 1990s and early 2000s. That is the phenomenon of the multinational contract manufacturers, and a lot of people in the high tech industry no longer manufacture their own products anymore. They have them made by these contract manufacturers. The contract manufacturers, the three largest in the world are Solectron, which is a Japanese company; Flextronics, which is a Taiwanese company; Celestica, which is a Canadian company. They all established manufacturing in the United States and all of those factories have now moved to China.

So, basically it has almost been a backdoor migration of high-tech manufacturing jobs from American multinationals to contract manufacturers based in the United States to contract manufacturers now based in China. So, that is probably why it hasn't been as visible as you might think.

Mr. ENGLISH. Mr. Trumka.

Mr. TRUMKA. I would supplement what he just said by saying the Mexican Government is just complaining that 520 factories, previous U.S. factories that had migrated to Mexico, have now moved to China in the last 18 months. So, while they weren't directly—they didn't directly migrate from the United States, they had a short-term stop in Mexico and then went to China.

The three things that I would say are currency enforcement; negotiate trade deals that have strong labor, environmental, and human rights provisions; and then enforce all the trade laws; overhaul the tax code to reward people who manufacture here.

Mr. ENGLISH. On that last point, Mr. Trumka, would you support border adjustability in the tax code?

Mr. TRUMKA. I am not sure what you mean by that.

Mr. ENGLISH. Well, I will go into greater detail with you some other time, then. What I have always felt is that we should change our tax code to allow us to take the tax off of exports at the border as they leave and at the same time put an equal, comparable, and fair tax on anything that comes in from overseas. Border adjustability is allowed under the WTO, but we have never availed ourselves of the option. For that reason when you gentlemen try to sell products made in the United States overseas, you have to include in the price the cost of the U.S. tax system, whereas your competitors frequently don't have to. That seems to me to be one factor that we control.

I want to thank all of you for your testimony, and I want to reiterate I want to thank the Bush Administration for strongly raising with the Chinese the issue of the yuan and its artificial peg. I realize we have heard testimony today from real live economists, unlike Mr. Somple, to the effect that maybe that isn't happening or it does not matter, but I think the balance of practical experience is that there is an enormous burden being placed on the U.S. manufacturing sector by the way the Chinese have been allowed to distort their currency notwithstanding their WTO commitment. I yield back the balance of my time.

Mr. PORTMAN. Thank you, Mr. English. A final round of questions here, and I want to give all four of you a chance to respond. First, Mr. Trumka, let me say it was music to my ears to hear you talk about overhauling the tax code, but I would encourage you to think more broadly. Mr. English talked about the idea of having a border adjustable system that is, as was talked about earlier, an indirect tax. We talked about the VAT that the Chinese have at the 17-percent rate, roughly, and that is applied to all of the U.S. exports going over there but not to the Chinese exports coming back this way.

They are not the only country that does this of course. All of our global trading partners do with maybe one exception, including the Europeans, and that is a differential that we deal with. Some economists say currencies will adjust, exchange rates will adjust, so it won't make much difference. I don't believe that to be true, and I think that would be something that you and some of your economists at AFL–CIO ought to look at as part of the answer.

I also think we need to focus on the fact that in terms of manufacturers in this country, most of the manufacturing jobs here in this country are multinational company jobs and this also goes to the issue of these markets. I talked earlier about the fact that I thought it was insightful to say that China presents an opportunity as well as a threat. The opportunity obviously is this is a growing marketplace for U.S. products and U.S. jobs and U.S. workers, and as someone who represents thousands of GE aircraft engine workers in Cincinnati, Ohio, where their headquarters are, China is obviously their biggest potential market and their biggest opportunity and the biggest way for those workers, both hourly workers who actually still produce some things in Cincinnati but also those workers who are salaried workers who do the research, who do the accounting and do the legal work, and there are thousands of them.

A company in my district Procter & Gamble has 20 percent of its workers in the United States only supporting international sales. Think about that. This again is thousands of workers. We have 14,000, Jeb, as you know, in our area.

So, this is a complicated issue. You don't want to have a tax policy in place that disadvantages U.S. companies from being competitive in these global marketplaces. We have a great market in this country, but it is not where the growth is, and if we are to continue our standard of living and continue to allow the United States to be this leader in innovation, in entrepreneurship, and so on, we have got to compete in these other markets.

If we are not there, other countries will be. That is what we talked about earlier. So, it is a complicated issue, because while I want to encourage people to keep jobs here, you also do not want to penalize those multinational companies because they are also adding tremendous value to our economy. Going to Bermuda is one way to get out of it.

Another way to get out of it is they become foreign companies. We had the Chief Financial Officer, or Vice President for tax, for what was the Chrysler Company—it is DaimlerChrysler today, not ChryslerDaimler, primarily because of the disadvantages they perceive and that are real, I believe, in our tax code and the way we tax our international companies. I would much rather them be ChryslerDaimler.

Mr. Head, you can respond—Mr. Trumka, if you want to that. I don't know if I have asked you a question.

Mr. TRUMKA. I don't think I have enough time to go into that one.

Mr. PORTMAN. Just broadening the view, but whatever the problem with China is, we are not as competitive as we need to be here as home.

Mr. TRUMKA. I would just reiterate this, Mr. Chairman. We understand multinational corporations. We understand where they go, but they shouldn't be rewarded for going there. They shouldn't be allowed to go to China and not pay overtime and not pay a minimum wage. That is not the type of rewards we should encourage or allow or even tolerate, because what that is going to do is encourage a race to the bottom. You heard three responsible employers that are saying they want to pay their people decent wages and decent benefits. They shouldn't be disadvantaged because there were no regulations, health and safety regulations, no environmental regulations, and those companies shouldn't be able to take advantage of that situation and send stuff into this market to the disadvantage of everybody that plays by all the rules. We need to have all the rules enforced and enforced fairly.

Mr. PORTMAN. Well, I think there has been a consensus here this morning about enforcing the rules. One of the questions is, what are those rules? With particular regard to the currency issue, we have heard from the experts on previous panels yesterday and earlier this morning that this is a difficult area because there is not a clear WTO violation with regard to pegging currencies. There is, however, the ability for us to influence that. I follow what Mr. English said. I am very concerned about it and I applaud this administration, including Secretary Snow, Secretary Evans, and the President himself for making that clear and for encouraging the Chinese at least to, as Mr. Trumka indicated earlier, say they were going to take certain steps not just with regard to purchases but with regard to the yuan. It has been more than 10 years now that they have done this. This is nothing new. Now we are beginning to see the effects of it, and we need to react to it.

Mr. Head, earlier Mr. Malpass made some comments in response to my anticipation as to what this panel was going to say. I tried to lay out as best I could what I thought you all might say. He is not here to be able to respond to you. I wish he were. If you could respond to him, that would be helpful. He basically said, number one, it is not new, and number two, he questioned whether a relatively low yuan was hurting us. He did not get into great detail on that, but part of what he was saying is historically if you look at this, it is not going to encourage investment, the Japan example he used.

Mr. Head, you talked earlier—rightly so—about the subsidy involved here and the benefit. I would say there is a benefit not just to companies that might import those products, but to our constituents, to all of us. Lower prices at the store are reflected in some of this and we have to acknowledge that as well. He talked about that too, that there is an economic relationship here.

Would you all like to respond to Mr. Malpass for the record so that we have a little dialogue between the two of you? Mr. Head, you start and open it up.

Mr. HEAD. Sure. I do think that we recognize, as Larry pointed out, that this subsidy—or if the currency were to rise, that prices would potentially rise in this country and that would be what would happen. I think that I would take the opinion that the lower prices, as they are based on what I would consider a subsidized rate, are artificial and unsustainable and that we shouldn't be depending on that.

In terms of one of the points that Mr. Malpass made that stable rates facilitate investment and that China is using a new model, I understand that. I think that there have been proposals that China could appreciate their currency or revalue their currency. Nicholas Lardy, who is a very I think qualified commenter on that, had suggested that they appreciate their currency by 15 or 20 percent in order to take the burden off of their system. This is creating overheating in the Chinese economy, as you might expect, because it is undervalued. I think that those proposals would allow for the Chinese to maintain this so-called steady rate that allows international investors to invest.

I take your point very well that foreign markets are the future for many companies, but when the playing field is imbalanced, when it is tilted against our favor, that does not help either domestic businesses or domestic businesses that want to expand their sales overseas.

Mr. PORTMAN. Thank you. Other comments Mr. Galbraith?

Mr. GALBRAITH. Yes. What we are talking about, the penetration of the Chinese into this market, let's talk about textile apparel for just one moment again. If the surge of textile apparels continues at the rate they are going to have when all the quotas go away in 2005—and they will—you are going to see an influx of apparel that we have never seen before. We are going to see the closing of manufacturing jobs, both in textile and apparel, that we have never seen happen since the Great Depression.

Now, once—we all know how to compete in business. So, if I buy my way into the market by pricing my goods ultimately low, once I drive out my competition, where do you think my prices are going to go? So, when I said prices would go up, they will. If we destroy our manufacturing base in this country, I assure you the prices will go up again. Once competition is gone away and I own the market, then I will put and price my goods respectively.

Mr. PORTMAN. Mr. Somple.

Mr. SOMPLE. I think I would just sum it up in terms of whether or not a pair of blue jeans costs $20 or $25 really is not that important to somebody who does not have a job. That is what I am facing up in New England, as a matter of fact. I forget the company, but the longest continuously operating company in the State of

Vermont announced last week they were closing down. They make machinery for the textile industry. They were down to 18 employees, and they had simply no one left to sell it to.

Yes, but I think that the facts that goods costs a little bit less right now is artificial. They are artificially lower prices and that will eventually go away due to market conditions.

Mr. TRUMKA. The other thing that I might just add quickly is I was a little astonished to hear him say that, as most economists kneel at the altar of the marketplace, that the marketplace should set that, the marketplace should set currency values. Yet when it came to currency and an obvious manipulation of a very, very large component of the marketplace, he was willing to brush that aside as if it does not matter.

We think it does matter. We think it disadvantages our manufacturers. We think it costs us jobs, and we do not think it should be tolerated any longer.

Mr. PORTMAN. Thank you. Any additional questions? Mr. Collins?

Mr. COLLINS. We were talking about the 40-percent advantage they have, disadvantage we have based on the subsidy. Are you familiar with a bill that has been introduced, and it is in this Committee waiting for hearing, called the fair tax? The national retail sales tax? It would be a retail sales tax on goods and services. It would replace the income tax, payroll tax, all Federal tax withholding. It would still be if there was a State tax withholding, we have no jurisdiction over that.

That same tax would be deducted from any exports because they would be retail sales, not wholesale. It would not be included in any export, not deducted but not included, and it would be added as a tax to all imports. Any thought on that?

Mr. TRUMKA. I have—my own answer was we haven't had a chance to look at it. I don't know if you directed the question to me or not.

Mr. COLLINS. Any of the four of you.

Mr. TRUMKA. I haven't had a chance to look at that. We are willing to look at virtually anything that can help us with the situation we find ourselves in. Manufacturing in this country is in a crisis and things that we can do to help them turn that crisis around we are willing to look at. I haven't seen that specific bill.

Mr. COLLINS. I would recommend you go to the Internet and look at it. It is called the fair tax. It does away with all Federal income tax, corporate tax, as well as the payroll tax. It adds a 23 percent, 22, whatever the numbers work out to be revenue neutral, to retail sales of goods and services, one-time sale only. No wholesale, no exports applied to it. It would apply to imports that are sold retail. I think that may move us back into more an advantaged situation than a disadvantaged situation.

I would like each of you to look at that, and we can send the information on it from my office or you can get it from the Committee here and give us some feedback on it. I think it would be very— we need that feedback. It would be good because we are trying to work toward scheduling some hearings on the fair tax.

Mr. GALBRAITH. Congressman, I assure you this panel—and I am speaking for all of them because I think we are willing, as my colleagues have said, to look at anything that will help us keep manufacturing competitive in this hemisphere.

Mr. COLLINS. There have been studies done on the fair tax that indicate that if there were any expansion by companies here, that it would be here. What would be the reason for going elsewhere? Based on the tax code?

Also it would also help to lure some manufacturing back here, because today oftentimes inversions are because of the tax code. There would be no need to invert. The tax code would not apply. We would be more competitive in the world market from the standpoint of exporting. The tax would not be included. It would be more competitive with the imports because the tax would be added.

Tariffs were put on years ago to equalize the difference between nations and production costs, costs of living. We have just about done away with all of that, but this would make a more balanced level playing field. Called the fair tax. A national retail sales tax on goods and services. Thank you.

Mr. PORTMAN. Thank you, Mr. Collins. We will have another hearing on tax policy, I hope, coming up. We had some good ones last year, and that was one of the topics raised: how to begin leveling that playing field internationally through consumption taxes.

This panel has been helpful to our overall look at the relationship between United States and China and China's role in the global economy. Thank you gentlemen very much for being here. I am going to ask Mr. Houghton, the Chairman of the Subcommittee on Oversight, to pose the final questions to you, and then the hearing will adjourn. Mr. Houghton.

Mr. HOUGHTON. Thank you. Mr. Chairman, as any politician, I am not sure I have a question; I would like to make a statement if I could, and if you want to challenge it, please do. First of all, thank you so much. This is not just an intellectual exercise, this is our livelihood. I have been in business for 35 years, and I know the blood and the sweat and the agony and all the other things that go with it.

The thing that we are facing—we have got a very unusual country. We have got high research response expenses, we have high educational expenses, we have high social expenses, and many other countries do not have that. We could call them on the subsidies they have. as far as the steel industry is concerned, that is unfair. If a country puts capital into an industry and we have to put private capital into an industry, it makes it unfair, and we can do things like that.

We could have a philosophy of do unto others as they do unto us. If that is the case, we are going to close all of our borders because nobody is going to play by the types of rules and the standards that we have played by.

So, the question is really: what are those things we are asking others to do and how are we using our comparative advantages? It is a messy area. It is not exact. There are no strict rules, but those are the conditions under which we have to operate. We all have to work together; business, the unions, the government, have to work together on this.

Mr. Chairman, this is not just a one-shot dialogue. This is something that has to go on, because if we do not wrestle with this—

and it is outside of the competitive dumping laws, it is entirely different, we have never had this thing before—that we are going to go down the drain. We cannot afford it.

There are ways we can look at this thing and work together, but somehow we have got to take a look at what are the conditions that we have got to face, rather than just telling horror stories and what are those comparative advantages and what are the things we ask logically of our competitors on the outside. I hope we can continue to do that, and I thank you very much for letting me be part of this discussion.

Mr. PORTMAN. Thank you, Mr. Chairman. Witnesses, again thank you for your input. As you know, you have the opportunity to submit additional comments for the record should you choose. We appreciate you being here, and this hearing is now adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Additional information for the record submitted by Mr. Crane follows:]

Washington, DC 20515
November 11, 2003

Ms. Allison Giles
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth HOB
Washington, DC 20515

Dear Allison:

I would very much appreciate inclusion of the following article in the Committee Record for the recent China Trade Hearing.

The article, a copy of which is attached, appeared in the November 2003 Chicago Fed Letter, a publication of the Federal Reserve Bank of Chicago. It details how U.S. trade with China has grown dramatically in recent years, and how China's rapid economic growth has benefited U.S. consumers. For example, for many U.S. companies, the opening up of the Chinese market represents an opportunity for growth in exports of U.S. manufacturing goods and services, or for investment and production in China. At the same time, the article points to some of the challenges the growth in imports from China presents for domestic producers to lower costs to remain competitive in global markets.

A copy of the letter is attached, and I thank you for its inclusion into the Committee Record.

Sincerely,

Philip M. Crane
Representative in Congress from the State of Illinois

Midwest manufacturing and trade with China

by William Testa, vice president and director of regional programs, Jay Liao, research intern, and Alexei Zelenev, associate economist

U.S. trade with China has grown dramatically in recent years. The growth in imports, in particular, has raised some challenges for domestic manufacturers competing against lower-cost Chinese production. At the same time, households benefit from falling prices for imported goods, firms benefit from falling prices on intermediate components and parts, and U.S.-domiciled multinationals benefit from selling to and investing in the burgeoning Chinese market.

As U.S. imports from China have climbed in recent years, some domestic manufacturers have voiced concerns about competing against low-cost Chinese goods in the U.S. market. At the same time, however, U.S. households benefit from falling prices for imported goods; firms benefit from falling prices on intermediate components and parts; and U.S.-domiciled multinationals benefit from selling to and investing in the burgeoning Chinese market. This *Chicago Fed Letter* examines our growing trade relationship with China, especially as it relates to the Midwest manufacturing economy.[1]

1. Import penetration of Chinese goods to U.S. regions

	IP Level *		Percent Change
Regions	**2001**	**1997**	**1997–2001**
East North Central	.023	.014	65.6
West North Central	.023	.014	65.0
South Atlantic	.024	.015	56.7
West South Central	.025	.016	58.9
East South Central	.027	.016	63.1
Mountain	.028	.017	63.3
Pacific	.031	.020	56.8
Middle Atlantic	.032	.021	53.1
New England	.039	.025	55.8
United States	.027	.017	59.5

* Figures are rounded to 1/1,000. IP is import penetration.

China's growth

Although the accuracy of Chinese gross domestic product (GDP) data is questionable, there is little doubt that China is experiencing rapid growth. Reported GDP growth averaged 9%–10% annually during the 1980s and 1990s.[2] China has been able to sustain much of this growth recently, when many of the world's economies have slipped below trend.

An increased openness to trade and investment has led China's growth. Since 1990, China's exports have grown at an annual pace of 14%; imports have grown apace.[3] Foreign direct investment (FDI) in China has averaged $44 billion per year since 1995, originating from developed countries on every continent.[4]

Prior to the 1980s, very little trade and FDI could be observed between China and developed countries. However, economic reforms beginning in 1978 launched China onto a robust path of export-led industrial growth and urban development. These reform efforts reached a milestone with China's entry into the World Trade Organization (WTO) in 2001. WTO membership promises greater attractiveness for China as a domicile for FDI, along with access to the markets of other member countries. In return, China has to comply with the rules of WTO membership, including nondiscriminatory tariff schedules on imports and the protection of intellectual property.

To date, China's internal policies have favored the build-up of domestically owned, mostly state-owned, industrial plants. In addition, China has selectively encouraged FDI, especially in manufacturing. Many of these FDI operations produce goods that serve the Chinese market, but many more are platforms to export goods back to their country of origin or to other markets. Indeed, trade statistics for China are difficult to interpret because, for one thing, re-export of goods is quite common. For some products, such as computers and other electronics, high-value-added components are shipped into China from countries such as Taiwan and Japan for further processing and ultimately re-exported. Typically, this processing takes advantage of the very low relative wages in China. This sometimes leads to double counting of underlying export values from China. From the U.S. perspective, much of what we

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[1] We define the Midwest here as Illinois, Indiana, Michigan, Ohio, and Wisconsin, which is also known as the East North Central region.

[2] The World Bank, 2003, *ICT's China at a Glance.* Others estimate China's growth at 7%–8% per annum.

[3] ibid.

[4] Ministry of Foreign Trade and Economic Cooperation of the People's Republic of China.

see as imports from China—especially in electronics—has other Asian country origins embedded in its value.

U.S. trade with China

From 1997 to 2002, trade volumes (combined exports and imports) between the U.S. and China increased at an average annual pace of 12.5%, reaching $147 billion last year. In comparison, trade with America's North American Free Trade Agreement (Nafta) partner, Mexico, increased at a pace of 6.3% annually. As a result, in 2002 China became our fourth largest trading partner after Canada, Mexico, and Japan.

Both exports and imports have grown rapidly, but China's imports into the U.S. have easily outpaced U.S. exports to China. Since 1989, the nominal dollar value of U.S. imports from China has multiplied more than eightfold, reaching $125 billion in 2002, allowing China to surpass Japan for the first time. China's manufactured exports to the U.S. represented 10.8% of manufactured imports for 2002.[5]

What has been the impact of rising imports on domestic U.S. manufacturing production? We sometimes think of rising imports as displacing production at home. Rather than displacing domestic production, however, rising imports may serve rising demand for some types of goods in the home country. So too, imports can consist of intermediate components that become embodied in domestic production of a final good. To the extent that such components are most cheaply sourced overseas, they may help keep domestic production competitive for the final good in the domestic market, or even allow domestic producers to export the final good to third country markets.

To understand the extent that domestic production is being superceded by imports, economists measure "import penetration" as the ratio of imports from abroad relative to the domestic market, where the domestic market includes goods purchased in the home country, regardless of whether the goods are produced at home or abroad. We use an index that ranges between zero and one, with a value of zero meaning that all domestic purchases are produced at home and a value of one meaning that all domestic purchases are produced abroad. For 2001, we estimate China's manufactured imports to be 2.7% of the U.S. domestic market—defined as domestic production plus imports—up from .4% in 1989.[6]

There are several reasons to believe that the growth in import penetration overstates the potential displacement of U.S. manufacturing production by imports from China. This is especially so when we consider that, owing to China's economic growth, *exports* from the U.S. to China have also expanded, lifting domestic production beyond what it otherwise would have been. Exports to China grew from 0.5% of U.S. manufacturing output in 1989 to 1.5% by 2002.[7] In addition, low-cost imports from China have restrained price increases and raised the real income of U.S. households, allowing them to purchase more goods—both domestic and foreign. An additional factor that is not easy to quantify is the extent to which China's exports to the U.S. are substituting for exports that would otherwise have entered the U.S. market from alternative low-cost countries.

U.S. manufacturing output growth has been weak, and year-over-year job growth in manufacturing has been negative for over 3 years. However, the bulk of the current U.S. manufacturing weakness cannot be attributed to rising imports and outsourcing. The overhang of excess capital goods investment and other production capacity continues to weigh on the pace of orders for new manufactured goods, as does the shallow U.S. economic recovery from the 2001 downturn. Moreover, flagging economic growth in developed countries in Asia, South America, and Europe continues to hold back U.S. exports. Most importantly, over the longer term, manufacturing jobs have grown at a slower pace than jobs in services, largely because productivity gains in manufacturing have exceeded those in most service industries.

It is also important to note that, so long as it is based on real production cost differences between the U.S. and China, import displacement frees up resources and workers in low-value production to pursue higher-value and higher-skilled activities in the U.S. economy, thereby raising average wages and living standards. Developed nations specialize in producing a rich variety of goods and services, trading with each other, and thereby sustaining mutually high standards of living. One measure

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[5] U.S. Census Bureau, "U.S. international trade in goods and services," No. FT–900, annual revisions issues.

[6] China's import penetration is measured as: $M(China)/(VS-X+M)$, or the ratio of Chinese imports to total domestic U.S. market, where X = all U.S. manufactured exports, M = all U.S. imports of manufactured goods, and $M(China)$ = imports of manufactured goods from China. *VS*, the value of manufactured shipments in the U.S., is reported by the U.S. Census Bureau, *Census of Manufactures and Annual Survey of Manufactures.*

[7] GDP by industry from the U.S. Bureau of Economic Analysis, U.S. Department of Commerce.

of the maturity of the trade relationship between developed countries is the Grubel-Lloyd Index, which measures the degree of intra-industry trade as a proportion of all trade. Between the U.S. and the UK, France, and Canada, for example, these indexes are quite high. For the U.S. and China, the index is lower, but it climbed significantly between 1989 and 2001.[8]

China and the Midwest

How important has China's emergence as a major trading partner been for the Midwest economy? One would expect growth in China's imports to have penetrated the region's domestic markets because the Midwest economy is more highly concentrated in manufacturing than other U.S. regions.[9]

We construct measures of China's import penetration for the range of finely disaggregated U.S. manufacturing industry sectors. Then, we compare overall import penetration between the U.S. and the Midwest by weighting these industry-specific national measures of import penetration by the employment importance of each industry in the Midwest.[10] We find that the penetration of Midwest manufacturing by Chinese production remains smaller than at the national level. For 2001, we estimate Chinese trade penetration of the Midwest to be 2.3% versus 2.7% for the whole domestic U.S. market (figure 1).[11] These average levels of import penetration put into perspective that China remains, on average, a small-to-moderate player in many U.S. (and Midwest) markets for manufactured goods.

However, China has become a dominant player in individual product categories, especially those that are very labor intensive. In particular, our estimates for 2002 suggest a Chinese market share for the U.S. of over one-half for certain categories of dolls and stuffed toys, fur and leather apparel, and women's handbags.

These are not product categories in which the Midwest specializes. Still, many small Midwest manufacturers have begun to voice concerns about the difficulty of competing on price with production operations in China. These concerns may derive from several sources. In particular, the manufacturing sector is hurting in the U.S., with output and employment performing below trend since late 2000. It may also be that the Midwest's industry base has only recently begun to experience significant import competition from China (figure 1). For the 1997—2001 period, we estimate that the Midwest experienced relatively higher growth in import penetration from China than other U.S. regions—a 65.6% increase from its base, compared with 55.8% for New England, and 53.1% for the Middle Atlantic (see figure 1). Furthermore, the product categories that contributed the most to the climb in estimated import competition include "all other motor vehicle parts," a category that is of critical importance to the Midwest. Other important categories that have seen strong import growth are institutional and metal furniture (especially in Michigan), printed circuit assembly, and household appliances.[12]

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[8] The index is based on the ratio of net to gross trade across for each industry, averaged across all industries (at a country level):

$GL = 1/n$ å$(1 - |X_i - M_i|/(X_i + M_i))$.

[9] As measured by GDP by industry (and gross state product for states), the Midwest concentration in manufacturing exceeded the nation by 46% in 2001.

[10] Specifically, import penetration in state i = Sum over all industries j MP^i, where $MP^i = L^{ij} \times MP^j$ and L^{ij} = state i's share of its own manufacturing employment employed in industry j, and MP^j = U.S. import penetration of good j.

State-level industry employment is drawn from the U.S. Dept. of Commerce, *County Business Patterns,* available (and used here) at the four-digit SIC (Standard Industrial Classification) level and the six-digit NAIC (North American Industrial Classification) level.

This regional weighting of national penetration ratios assumes that 1) local industries sell into the U.S. market, and 2) employment by industry accurately reflects industry production in each state.

Imports and exports by country, which are mapped from international harmonized system categories into SIC and NAIC codes, are reported at http://data.econ.ucdavis.edu/international/. Also see Robert C. Feenstra, John Romalis, and Peter K. Schott, 2002, "U.S. imports, exports, and tariff data, 1989—2001," National Bureau of Economic Research, working paper, No. 9387, December.

[11] The import penetration (IP) measure that we calculate above does not take into account the size of the manufacturing base in each region. In view of this, we weighted the regional IP by an index value based on the share of each region's overall GDP in the manufacturing sector. The import penetration thereby increased in regions with more concentrated manufacturing relative to the nation and decreased in regions with less concentrated manufacturing. The largest change was in the East North Central region; the IP measure increased by 38%, making that region's import penetration among the highest in the country. By contrast, the IP of the Mountain region decreased by 34% and ranked toward the bottom.

[12] We corroborate these numbers by examining average annual growth in U.S. imports from China for both the U.S. and Midwest (top industries are proxied by rankings of industry employ-

Continued

To illustrate the price pressures currently being experienced by U.S. auto parts suppliers, automakers have reportedly been asking suppliers for the "China price" on their purchases.[13] Some suppliers have been asked to relocate or outsource at least some operations to China—either to better serve customers overseas or to stay price-competitive in domestic sales.

So far, overseas shifts of factories and capital from the U.S. to China have been substantial, but far from extraordinary. U.S. flows of foreign direct investment into China have climbed rapidly, doubling since the mid-1990s.[14] However, for 2002, this FDI accounted for just 8% of total FDI into China, with countries of the Pacific basin investing much more in aggregate. In particular, FDI from Hong Kong, Japan, Korean, and Taiwan accounted for 42% last year. For these countries, investment represents a way to cut costs and stay competitive. Often, their production operations involve reshipments and trade across multiple countries, with components and parts sent to China for (labor-intensive) assembly or further processing and then shipped home or exported overseas. In this way, China functions for Asian manufacturing companies much as Mexican *maquiladora* plant locations do for many U.S. producers.[15]

Likely because of its distance from the U.S., China has not tended to function as a platform for U.S. manufacturers to produce goods for the U.S market. In the latest reported year, 2000, only 13% of the sales of U.S. multinationals producing in China were shipped back to the U.S. Instead, two-thirds of their products were sold to the Chinese market. The pattern is even more pronounced for machinery and chemicals, both of which are important industries in the Midwest. However, some U.S. FDI affiliates in China may serve to contract with China-owned plants for export to the United States. This phenomenon is not reported on nor has it been investigated to date.

With its robust development and rapid growth, China has become a growing market for U.S. (and Midwest) exports. But while U.S. exports to China have grown rapidly since 1988, they as yet comprise only 1.5% of the value of U.S. manufacturing production. Some regions, such as the Far West, have parlayed their concentration in computing equipment and other electronics up to a 3.6% production share. However, the Midwest exports only .6% of its manufacturing production to China.

Conclusion

China's rapid economic growth has benefited U.S. consumers. And, for some U.S. companies, the opening up of the Chinese market represents an opportunity for growth in exports of U.S. manufacturing goods and services, or for investment and production in China. At the same time, the growth in imports from China is challenging domestic producers to lower costs to remain competitive.

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ment in the region). For an aggregate of the import categories for the 30 most prominent categories measured at both four-digit level and five-digit level product codes, we find greater import growth in the Midwest than in the nation.

[13] See Robert Sherefkin and David Sedgewick, 2003, "Ford, GM push vendors toward China: 'World price' frenzy threatens U.S. jobs," *Crains Automotive News,* June 23, pp. 1, 38.

[14] Chinese agencies report annual FDI figures four times higher than reported by U.S. agencies.

[15] A recent theme has been that Mexico is losing favor as a location of production to China. See "The sucking sound from the East," in *The Economist,* July 26, 2003, pp. 35–36. Domestic automakers often have labor-intensive parts of their production value chain, such as the wiring of interior consoles on automobiles for example, performed in Mexico and shipped back north for final installation into the automobile.

[Submissions for the record follow:]

Statement of AdvaMed

AdvaMed represents over 800 of the world's leading medical technology innovators and manufacturers of medical devices, diagnostic products and medical information systems. Our members are devoted to the development of new technologies that allow patients to lead longer, healthier, and more productive lives. Together, our members manufacture nearly 90 percent of the $71 billion in life-enhancing health care technology products purchased annually in the United States, as well as 50 percent of the $165 billion in medical technology products purchased globally. Our industry enjoys a trade surplus of over $7 billion vis-à-vis our trading partners.

Global Challenges

Innovative medical technologies offer an important solution for industrialized nations, including China, Japan and European Union members that face serious health care budget constraints and the demands of aging populations. Advanced medical technology can not only save and improve patients' lives, but also lower health care costs, improve the efficiency of the health care delivery system, and improve productivity by allowing people to return to work sooner.

However, when regulatory policies and payment systems for medical technology are complex, non-transparent, or overly burdensome, they can significantly delay or deny patient access to the latest, state-of-the-art innovations. They can also serve as non-tariff barriers, preventing U.S. products from reaching patients in need of innovative health care treatments.

AdvaMed applauds the ongoing efforts of Congress and the Administration to hold China to its international trade commitments. We thank the Ways and Means Committee and the House for their leadership in holding this hearing and for their interest in leveling the playing field for American companies in the important China market. AdvaMed also supports the pursuit of additional U.S. trade agreements with key global markets in Latin America and the Asia Pacific regions, and would welcome the opportunity to provide input into this process to ensure the furtherance of U.S. trade in the medical technology sector.

AdvaMed believes the U.S. Trade Representative's Office, the U.S. Department of Commerce and Congress should continue to monitor regulatory, technology assessment and reimbursement policies in foreign health care systems, including the increasingly important China market, and push for the creation of transparent, open and inclusive decision-making processes. We look to Congress and the Administration to actively oppose excessive regulation, government price controls and arbitrary, across-the-board reimbursement cuts imposed on U.S. medical devices and diagnostics in China and elsewhere.

Continued U.S. Leadership Urgently Needed to Fight Trade Barriers in China

For the medical technology industry, the Bush Administration's efforts with China under the U.S.-China Joint Commission on Commerce and Trade are critical for allowing U.S. medical technology firms broader access to the burgeoning Chinese health care market. Moreover, the nascent U.S.-China Health Care Forum initiative, led by the U.S. Department of Commerce and supported by AdvaMed and many of its health care partners, holds great promise as another vehicle for addressing many of the trade- and health policy-related barriers confronting U.S. medical technology firms in China.

China has quickly become an important market for the U.S. medical technology sector. While solid statistics are not widely available yet, AdvaMed estimates that the Chinese market for medical technology is approximately $3 billion and growing rapidly. It is on pace to surpass some of the key European markets for medical technology in a few short years. As global leaders, U.S. medical technology firms already account for a significant portion of sales in China and are poised for greater growth there. The position of these firms underscores the importance of ongoing efforts with the U.S. government to open the Chinese market further to life-saving and life-enhancing medical technologies.

Key Areas of Concern in China

AdvaMed and its member companies have identified a number of real and potential barriers to doing business in China. While most of the barriers pertain to unnecessary or redundant regulatory requirements, there are increasingly concerns in the areas of reimbursement and intellectual property. AdvaMed looks forward to working with Congress and the Administration to address these barriers, thereby helping

U.S. medical technology firms and helping improve patient access to medical technology in China.

- *A Timely and Costly Product Registration Process*—China's state-sponsored testing laboratories handle product registration and testing. These labs are inefficient and often unable to handle the increasingly enormous workload generated by the introduction of new technologies. This adds substantial costs and time to the process of selling new medical technology in China. The Chinese Government should be encouraged to implement its own requirement that the State Food and Drug Administration accept "third party" review of products when state laboratories are unable to perform testing in a timely fashion.
- *Redundancy in the Registration Process*—China should eliminate the duplicative testing requirements of the various state agencies involved in the regulation of medical technology. In some cases, U.S. medical technology firms must comply with the requirements of more than three state agencies. This adds to the time and cost of getting technologies to the marketplace in China.
- *Antiquated Type Testing Requirements*—China should move toward the internationally-recognized quality systems approach to regulation, which focuses on auditing manufacturing processes rather than type testing individual product samples to ensure quality products.
- *Lack of Transparency in Decision-Making*—As part of its commitments to the World Trade Organization, China agreed to adopt a reasonable period for stakeholder comment on any contemplated laws and regulations. In the area of medical technology, this type of promised transparency and openness is not apparent. China should be held to its commitments in this regard by notifying stakeholders—including industry—of new laws and regulations and allowing an ample time for comment.
- *Inappropriate Price Controls*—Recently, the Shanghai Pricing Bureau proposed mandatory price ceilings for medical technology, as a way to address concerns related to alleged excessive margins charged by distributors. The resulting prices would have served as a disincentive to sell medical technology in the important Shanghai market. In addition, the pricing bureau would have required proprietary business information from U.S. firms with no assurances that the information would have been protected. After a series of discussions, AdvaMed, in conjunction with the local American Chamber of Commerce and U.S. Government representatives, was able to get Shanghai authorities to accept a mutually beneficial alternative. There is some concern that authorities in Shanghai may be failing to live up to its end of the agreement; therefore, careful monitoring on the part of industry and the U.S. Government will be critical.

  In the future, China should be encouraged to steer clear of onerous price control mechanisms like the aforementioned Shanghai scheme, with an eye toward establishing payment mechanisms that take into account the following principles:

  - All manufacturers of medical technologies should have an opportunity to submit a dossier that contains a recommended reimbursement level with supporting data;
  - All manufacturers (as well as any interested stakeholders, i.e. physicians, patients, etc.) should have the opportunity to provide input into the reimbursement decision-making process through discussions with appropriate officials;
  - Reimbursement decisions should be made transparently and within a reasonable 30–90 day timeframe;
  - Reimbursement decisions should fully reflect the medical, quality of life and economic benefits of medical technology; and
  - All manufacturers should have the opportunity to appeal a reimbursement decision before it is made final.

- *Counterfeiting of Medical Technology*—AdvaMed's member companies continue to identify instances of counterfeiting in China. This undercuts the ability of U.S. medical technology firms to sell in the marketplace and may also pose a serious safety threat to Chinese patients. China should be encouraged to beef up its national crackdown on the production and sale of counterfeit medical technologies.
- *Parallel Trade of Medical Technology*—The re-importation into China of medical technology is becoming a concern of AdvaMed's member companies. Re-importation can present serious safety concerns, particularly when there are product complaints or adverse events involving medical technology not imported by the manufacturer or its authorized representative. Typically, these re-imported products are expired or mislabeled and come without the necessary technical support, thereby raising the risk of damage or unfitness for use.

Conclusion

AdvaMed appreciates the commitment of Congress to work with the Administration and industry to expand trade opportunities with China. We look to the President and members of the House Ways & Means Committee to aggressively combat barriers to trade in China. AdvaMed is fully prepared to work with Congress, the U.S. Trade Representative's Office, and the U.S. Department of Commerce to help monitor, enforce and advance existing and future trade agreements with China.

Statement of Brad Smith, American Council of Life Insurers

Overview

The U.S. insurance industry strongly supported PNTR for China because the Chinese accession package was extremely broad and deep, and when fully implemented holds the promise of opening the vast Chinese insurance market to U.S. insurance and retirement security providers. We were aware from the outset that no agreement is self-implementing, and that the key to realizing successful profit from Chinese accession to the WTO is an efficient and transparent implementation process.

With the ongoing leadership and support of the U.S. Government trade negotiators and facilitators, ACLI and our property casualty counterparts at the American Insurance Association have established what we consider to be a positive implementation dialogueue with the Chinese Insurance Regulatory Commission (CIRC), which has already led to a much improved communications and transparency process for U.S. insurers in China.

Based on draft regulations just released by CIRC, we are cautiously optimistic that our primary concern to date (unjustifiably high capitalization requirements) has largely been addressed. As the next step, we have submitted a detailed list of additional questions to which we are seeking clarification from CIRC. We are optimistic that the United States Trade Representative ("USTR") will be able to schedule a meeting to review this agenda by the end of the year.

Background

China's formal membership in the World Trade Organization offers great promise and opportunity for life insurers. The ACLI and the broader U.S. Insurance industry, especially our property casualty counterpart—the American Insurance Association, were strong supporters of Permanent Normal Trade Relations (PNTR) for China because the insurance liberalization commitments contained in China's schedule of specific commitments and "Working Party Report" were broad and deep, holding the promise of opening the Chinese market to U.S. insurance companies and pension providers. Through experience with bilateral insurance agreements in Japan and South Korea, we knew at the time of China's accession that no agreement is self-implementing, and that the most important part of the opening of the Chinese insurance market would be in the implementation phase.

With China now in the WTO, through the good offices of the U.S. Trade Representative, the U.S. Commerce, State and Treasury Departments, and through the communications of many interested members of Congress, we (ACLI and AIA) have begun the process of establishing a dialogueue with the Chinese Insurance Regulatory Commission (CIRC) about the implementation of their liberalization commitments. Establishment of regular, straightforward two-way communication is, in our opinion, the best way to avoid possible misunderstandings, frustrations or disappointment about China's liberalization process.

The task before CIRC is substantial, as it is in everyone's interest that the Chinese insurance market not only be open but well run and prudentially sound. Our intent is therefore to make a positive contribution to this process, by providing CIRC and other Chinese decision makers our comments on their implementing regulations, and where appropriate, include technical research to help them in setting standards that meet the test of prudential justification.

Individual company experience with CIRC varies greatly. Some describe relations as perfect and others describe them as frustrating, but our member companies support this constructive engagement approach for the same reasons many companies have funded representative offices all over China, some going back for more than ten years. The Chinese market is seen to have tremendous potential, and many U.S. companies, like our international competition, see entry into China as key to a global strategy. Recent industry press headlines such as "Chinese Insurance Premium Grew 33% For First Seven Months" and "China Will Be Second Largest Insurance

Market by 2032, Says IBM", typify stories of the growth of the market since first being liberalized in 1992—we intend to be part of that.

With regard to China's implementation of their WTO insurance commitments, while the process is moving forward, the lack of clarity in the regulatory process has slowed and confused the fulfillment of China's insurance liberalization obligations.

Since joining the WTO in December of 2001, Chinese insurance regulators have promulgated five sets of regulations with the stated intention of implementing China's WTO insurance commitments. The first set went into effect in early February of 2002 and provided a general framework for the regulatory structure but offered little specificity regarding the implementation of their liberalization commitments. Procedures for branching, capitalization and solvency regulation and other fundamental processes by which U.S. insurers could procure a license and begin operations were not included. U.S. insurers provided an analysis of these regulations for USTR, pointing out the vagaries of the regulation as well as several specific regulatory articles that could be inconsistent with China's WTO obligations. USTR then met with Chinese regulators to communicate these questions and concerns and were told additional regulations would be forthcoming.

Chinese regulators subsequently released a second set of regulations in late February 2002 to further clarify the licensing procedures. USTR again communicated directly with CIRC regarding questions and concerns, which still had not been clarified. CIRC informed USTR of further forthcoming regulations and stated that China would fully implement their WTO liberalization commitments.

Concurrent with this informal bilateral dialogueue, USTR had requested answers to a detailed set of the same questions at the Transitional Review Mechanism discussion in the WTO Committee of Trade in Financial Services. This engagement has been continued at each subsequent CTFS meeting, with the same questions being echoed by the Governments of Canada, the European Union, Australia, South Korea and Switzerland.

Based on both the formal requests in the CTFS and the informal bilateral dialogueue, in October of 2002, Ambassador John Huntsman requested a meeting with CIRC that would be open to a small number of U.S. and Chinese insurance industry representatives as well as USTR representatives. At the suggestion of USTR, it was decided to focus exclusively on the highest priority issue—capitalization levels required of an initial establishment of a foreign insurer, and subsequent capitalization required when additional branches would be opened.

Our concerns were that the regulations were unclear because of conflicting overlap from multiple regulations, and because the amounts called for were well outside of prudentially justifiable international norms, thus creating a barrier to entry for many U.S. insurers. Our objective for the meeting was to seek clarification of the specific requirements, and to provide information on international benchmarks for prudentially justifiable capitalization levels. Thanks again to USTR, the U.S. Embassy in Beijing and the U.S. Commerce Department, on December 13, 2002 we participated in a meeting in Beijing with CIRC, Chinese industry representatives and a U.S. Government and industry delegation headed by Deputy Assistant USTR, Charles Freeman.

Our presentation, attached for entry into the record, was entitled "A Recommendation for Revisions to the Capitalization Requirement Rules for Life Insurance Companies Operating in China", highlighted just how far outside international norms China's capitalization levels were, and presented a model that our consultant, Watson Wyatt Insurance Consulting Limited, felt might be more appropriate for the Chinese life insurance market. CIRC listened, agreed that our worst-case projection of the capitalization requirements was currently correct, stated that there were plans to revise the relevant regulations, and agreed to consider our views.

Meanwhile, we discussed our capitalization concerns with other service industry groups in the U.S., Canada, Europe and Japan, fellow members of the "Financial Leaders Group" and found that our capitalization concerns were not unique. Service sectors such as banking, securities, auto finance and express delivery are facing similar problems. Thus, in February of 2003, the Financial Leaders Group delivered a letter to Chinese officials commenting on the prudentially unjustifiably high capitalization levels in many services sectors, including insurance, and the issue was again highlighted at the CTFS meetings in Geneva by the Quad Governments. CIRC subsequently stated that additional regulations to fulfill China's WTO liberalization commitments would be forthcoming.

It should be noted that neither of the first two insurance regulations were publicly released in draft for public comment. The U.S. industry provided comments anyway: No formal response was received.

On July 31, 2003 a third set of regulations ("The Draft Trial Implementing Rules on the Regulations of the PRC on the Administration of Foreign-Invested Insurance Companies") were placed on the CIRC website with a request for public comment by August 15. To our surprise, on August 18, 2003, another set of regulations ("Draft Administrative Regulations on Insurance Companies of the People's Republic of China") was also posted to the CIRC website requesting public comment by September 16. In both instances, we translated the draft regulations and circulated them widely within the U.S. insurance industry.

Also, in both instances, we submitted formal written responses to CIRC within the requested time frame. We commended them for their public outreach, and stated that their openness supports our firm belief that the most important factor contributing towards the successful development of the Chinese insurance sector will be the institutionalization of a regular and robust public dialogueue. We expressed our hope that this initiative can be expanded through increased communication and cooperation with interested international companies and industry associations, and committed ourselves to provide professional and timely responses to CIRC on an ongoing basis. We also stated that a dialogueue on these drafts and/or any revised drafts that CIRC circulates for additional comment would be an excellent basis for continuing the dialogueue we began last December in Beijing.

The major notable development in these recent drafts is a significant lowering of the required capital for initial establishment and full national operations, which, if implemented, bring the capitalization requirements closer to the acceptable range of international comparables for some lines of business and business models. This is a major step forward for CIRC, which we feel supports the benefits of continued dialogueue. We plan to extend this dialogueue to now include our other priority areas of concern.

Continuation of this dialogueue must be two-way. Many of our concerns involve confirmation of our understanding of the meaning of vague or conflicting regulations. So that this dialogueue is as clear as possible, we hope to receive written responses to our inquiries from CIRC. This has also been requested by USTR. We look forward to a meeting in Beijing to focus on this agenda by the end of the year, and greatly appreciate USTR's efforts to schedule it.

Top priorities we would like to have included in the dialogueue agenda are (by category of type of issue):

Fundamental Assumptions

We seek confirmation of the following fundamental assumptions, which are key to our understanding of the prudential intentions of the Chinese Insurance Regulatory System.

Fundamental Assumption—1

That CIRC is undertaking, through measures to date and in the future, an approach consistent with the PRC's WTO obligations regarding market access, national treatment and transparency, and that the only discrimination (differences) between provisions for domestic and foreign insurance companies is where there is a clear and necessary prudential justification. Furthermore, that it is the goal of CIRC is to have one set of regulations and procedures for domestic and foreign companies, so that the regulations are consistent with China's WTO commitments.

Fundamental Assumption—2

That there are three (3) documents/rules/regulations relevant to this exercise. They are (working back from the present): (A) the Draft Insurance Company Administrative Regulations (hereinafter the "Measures."); (B) the Draft Trial Implementing Rules on the Regulations of the PRC on the Administration of Foreign-Invested Insurance Companies, July 31, 2003 (hereinafter "Implementing Rules"); and (C) The Administrative Regulations on Foreign-Invested Insurance Companies of the PRC, Feb. 2002 (hereinafter the "Administrative Regulations").

Fundamental Assumption—3

That the three documents are each intended to accomplish a specific regulatory function and that there is no intentional overlap or conflict between the provisions of the three documents, especially with regard to the application of measures as between domestic and foreign companies.

Fundamental Assumption—4

That only the "Implementing Rules"; and the "Administrative Regulations" are applicable specifically to foreign companies.

Fundamental Assumption—5

That the "Measures." are relevant to all companies both domestic and foreign equally without discriminatory interpretation.

Implementation Gaps

We would like written responses to three questions regarding gaps in the regulations where they should reference major elements of the implementation of China's WTO liberalization commitments:

Implementation Gap—1

It should be noted in the "Implementing Rules" that several existing joint venture companies have foreign registered capital interests that are above 50%. It should be confirmed that these companies, and any subsequent foreign companies approved by CIRC to own more that 50%, are grandfathered in accordance with China's WTO commitments, and that such companies will be allowed to expand geographically (through branches and sub-branches) in their current ownership structure.

Implementation Gap—2

Prior to China's WTO accession, a number of foreign insurance companies were allowed to establish operations in the PRC. All of these companies were requested by the Chinese Government to incorporate as operational branches, not as subsidiaries.

However, in both of the two new sets of draft regulations (the "Administrative Regulations," and the Implementing Rules"), there does not appear to be any article that addresses the maintenance and development of these branch operations. We believe a section should be added explaining the administrative procedures under which a "guaranteed branch/sub-branch structure" should be allowed to operate. (By "guaranteed branch/sub-branch structure" we mean branches and sub-branches whose solvency is guaranteed and supported by the total assets of the parent company.) The branch/sub-branch structure is a well-established international norm appropriate for application in China. Accordingly, regulations should be developed to govern those branches already established in China and such future branches that may be established in China. We recommend that these regulations conform to the internationally accepted branch/sub-branch operating structure.

Indeed, in most countries and in accordance with international norms, when insurance companies enter foreign markets, they are allowed to establish an initial branch or home office and then expand to new locations throughout the country through a network of sub-branches. These sub-branches report to the original branch or home office.

This branch/sub-branch structure is supported by, and legally tied back to, its corporate parent. Thus, branch operations should not be treated as if they were separate, stand-alone entities. Likewise, because a branch/sub-branch structure is supported by its parent corporation's assets, the company should not have to re-capitalize when expanding to a new location. This branch/sub-branch operating structure is an established international norm and a widely accepted principle of operation.

For property casualty insurance companies the ability to expand by sub-branch is particularly important. Foreign insurance companies should be allowed to expand geographically in the Chinese insurance market in accordance with established international norms and operating practices (i.e., through the use of the internationally accepted branch/sub-branch structure). Specifically, foreign insurance companies should be able to establish a branch (with a reasonable initial capitalization) backed up by the strength of the parent organization, and be allowed to expand throughout the country—in accordance with China's timetable for the phase-out of geographical restrictions—through the establishment of sub-branches. The establishment of sub-branches should not be limited to the immediate, licensed region or territory. Also, the company should not have to separately capitalize each new location.

We also request clarification with respect to branch boundaries. We believe that it is more efficient to establish provincial-level branches rather than only municipal-level branches. Domestic companies are able to operate at the provincial level with access to all cities and localities in the province. To date foreign companies have received approval to operate at only in one specific city. Foreign companies like their domestic counterparts should have provincial level licenses.

The proposed rules are also silent as to their impact on existing insurance company operations, including existing branches. It is, therefore, assumed that branches and other insurance company operations that exist today may, but are not required to, continue to operate under the conditions and approvals that existed prior to this rule, including but not limited to operations, financial structure, capital and mode of establishment. This understanding should be confirmed.

Implementation Gap—3

In addition to its insurance and reinsurance liberalization commitments, China committed to liberalize its pension market within five years of joining the WTO. To date, no regulations or laws have been released in anticipation of the opening of this important market sector. CIRC or other relevant authorities, should begin a public comment process well in advance of the approaching phase in deadline to gain the broadest level of comment and support for this fundamental undertaking.

National Treatment Questions

In addition to the questions on fundamental assumptions and the further information needed to fill the implementation gaps, we would also like to receive confirmations from CIRC on the following specific questions regarding national treatment.

National Treatment Question—1

RE: Article 3 on the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. If we understand this correctly we interpret it to say that with respect to branch boundaries for foreign invested insurance companies, that they are treated the same as domestic companies which we understand are defined at the provincial-level (On May 21, CIRC approved Min Sheng Life to prepare 4 branches in Beijing, Nanjing, Hangzhou, and Shijiazhuang. (Source: China Insurance News, June 2003) If this is a correct understanding we believe that it is more efficient, and is a major step forward for CIRC in fulfilling their mission to implement China's WTO national treatment obligations. Domestic companies are able to operate at the provincial level with access to all cities and localities in the province. To date foreign companies have received approval to operate at only in one specific city. Foreign companies like their domestic counterparts should have provincial level licenses.

National Treatment Question—2

RE: Article 11 on the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. If we understand this correctly, we interpret it to say that with respect to branch applications for foreign invested insurance companies, that they are treated the same as domestic companies which we understand can apply for any number of branch approvals simultaneously with no limit to the number of branches a company may be granted at any given time.

National Treatment Question—3

RE: Article 13 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. As there is no reference to any waiting period, we request confirmation in this article that no waiting period exists before licensed insurance companies, domestic or foreign, can apply for branch or sub-branch licenses.

National Treatment Question—4

RE: Article 99 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. As it is so vague, we are concerned that Article 99 could be used to justify discrimination against foreign insurers, contrary to China's WTO commitments on national treatment. Accordingly, we would urge confirmation that the scope of Article 99 is limited solely to matters where the prudential justification will be clearly explained and limited to as least discriminatory as possible.

Prudential Justifications

In addition to the questions on fundamental assumptions, the further information needed to fill the implementation gaps, and questions of national treatment we would also like to receive responses from CIRC on the following questions of prudential justification.

Prudential Justification—1

RE: Article 6 (b) of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. We would like to understand the prudential reasoning behind the capitalization requirements. We believe that RMB200 million is too prescriptive in nature and may be much higher than international norms with respect to specific business models and risks being assumed. We feel that CIRC should be granted the discretion to lower this amount where it feels appropriate. Also, we request clarification of the scope of the initial establishment of RMB 200 million. Please confirm that this includes the right to establish sub-branches without limitation as to numbers.

Prudential Justification—2

RE: Article 12 of the August 18th Draft of Administrative Regulations on Insurance Companies of the People's Republic of China. We would like to understand the prudential reasoning behind the branching capitalization requirements of RMB20 million for each additional branch. We feel this is duplicative, contrary to China's WTO commitments, and has no prudential justification. Additionally we feel it is an inefficient use of capital, which will raise the cost of products to Chinese consumers.

In summary, it is vitally important that all parties work together in a clear and open manner to ensure understanding of CIRC's implementation process. Any measures China implements that give the impression of falling short of its WTO commitments and denying U.S. insurance companies meaningful market access in China could create hostility. Thus, it is in the interests of CIRC to continue a meaningful two-way dialogueue to make the implementation of China's WTO insurance commitments as smooth and positive as possible.

ACLI and our industry colleagues appreciate the hard work and high-level leadership of USTR and the other relevant U.S. Government agencies that have helped establish and grow this dialogueue with China. Likewise, the industry greatly appreciates the ongoing support of Members of Congress. We consider ourselves still at the beginning of a complex process, and will look forward to an ongoing relationship with your committee as we proceed through the years to come. While we do not know when China's draft regulations will enter into force, it is our hope that our dialogueue, with your and the government's assistance, will produce a transparent and effective body of regulations comporting with China's strong and admirable WTO commitments. We will report to you as circumstances develop.

Thank you for your interest and consideration in this matter.

Statement of American Iron and Steel Institute

The American Iron and Steel Institute (AISI), on behalf of its U.S. member companies, is pleased to provide written comments to the House Committee on Ways and Means regarding U.S.-China economic relations.

China's trade surplus with the United States, which is expected to be close to $140 billion in 2003, is unsustainable. The unsustainable U.S. trade deficit with China has its roots not in genuine Chinese comparative advantage, but in illegal and unfair Chinese trade practices. It is time to use our most valuable asset—the U.S. market—as leverage to level the international playing field and force China to compete on a fair trade basis.

In recent years, as more and more manufacturing facilities move offshore, we have become increasingly concerned about the phenomenon of the "disappearing customer." In particular, we have become concerned about the flight of domestic metalworking customers to countries such as China that rig their currencies, cheat on the rules and manipulate the "market" value of inputs and that relationship to eventual price.

China alone is not responsible for the U.S. manufacturing base having lost over 2.8 million jobs since 2000. However: (1) illegal and unfair Chinese trade practices have contributed significantly to the structural challenges facing U.S. manufacturers; (2) they have had a devastating impact on our entire manufacturing base; and (3) unless we recognize and address this problem, we will face even greater damage to U.S. manufacturing and living standards. To begin to reverse the damage, AISI supports—as a start—enactment of the NAM policy agenda to reduce the cost of doing business in the United States, level the international playing field and promote innovation and investment. Unfortunately, this agenda—especially on trade—will not be nearly enough to reverse the current negative trends.

China and the Need for a Bold and Innovative U.S. Trade Policy

As the U.S. steel industry recently told the Commerce Department: only bold and innovative public policy can reverse these negative trends. In trade policy, we need to do more than jawbone our trading partners, promote exports and sign new free trade agreements (FTAs). To compete against China and other mercantilist states, we must:

- Enact policies that will actually reduce the unsustainable U.S. trade deficit;
- Recognize the vital importance of the import side of the U.S. trade equation;

- Be willing to use the U.S. market as leverage;
- Use Section 301 to address the problem of currency manipulation;
- Enforce aggressively all U.S. trade laws and trade agreements;
- Strengthen significantly U.S. trade laws;
- Counter “industrial targeting” by China and others countries;
- Resist trade law weakening through international negotiations;
- Achieve fundamental reform of the flawed WTO dispute settlement system;
- Pass legislation to set up a WTO Dispute Settlement Review Commission;
- Retain the Continued Dumping and Subsidy Offset Act.

We also believe that, as part of the solution, we should take better advantage of the potential unrealized synergies in North America in terms of manufacturing. In this regard, we believe it would be useful to explore the potential for beneficial policy coordination among the governments of the United States, Canada and Mexico in an effort to promote more manufacturing in the U.S. and North America.

China and Steel

For decades, steel has been at the cutting edge of international trade disputes, and it will remain so in any discussion of the future of U.S.-China trade relations. To put things in perspective, China is now the main driver of the world steel industry. It is by far the largest, and fastest growing, producer and consumer of steel in the world. Steel production in China now accounts for one fourth of total world steel production, and steel output in China will soon surpass that of Japan and the United States—combined. China is also currently the world’s largest steel importing nation. It has the ability by itself to help cause a sudden, sharp rise—or fall—in world steel export prices. It is currently helping to lift steel prices globally off their previously very depressed levels. At the same time, it is helping to cause a worldwide spike in the cost of freight rates for bulk cargo ships and in the cost of steelmaking inputs around the globe. China this year is expected to account for just under a third of world steel consumption—and roughly 5.2 of the 6.4 percentage point growth in global steel demand.

Against the background of continued, massive global excess capacity in steel, China is pursuing major steel capacity expansions, aided by government financing. Many of these expansions involve the re-use of antiquated, and often environmentally unfriendly, facilities. Notwithstanding China’s dynamic growth, there are real concerns about over-investment in steel and other industrial products. Outside analysts are already predicting that excess supply in cold rolling and galvanizing steel processes could reach 12 million tons this year. In view of the enormous growth in Chinese steel capacity and in Chinese steel consumption in recent years—if the Chinese economy were to weaken even slightly—this could unleash a flood of steel into an already saturated global market. That, in turn, could cause significant harm to world steel markets, including serious damage to the U.S. steel industry recovery.

China continues to implement a range of policies in the steel sector that, whether WTO illegal or not, distort the market and could result in injury to the U.S. steel industry. These measures traditionally include:

- Massive subsidies provided through export and import substitution programs;
- State-orchestrated mergers and debt-for-equity swaps;
- Encouragement of output restraint cartels;
- Rebating of a value added tax in a manner designed to foster exports in a number of designated sectors, including steel.

Of particular concern is that many Chinese steel companies—at least 65 by the end of 2002—remain under the de facto control of the government. These state-owned-enterprises (SOE’s) accounted for around 50 billion RMB (about $6 billion) in capital expansion expenditures in the Chinese steel industry in 2002, which continued to contribute to the Chinese steel industry’s overcapacity in key steel product lines.

Low-interest-rate financing continues to be a concern in China’s steel industry. The government of China recently targeted six industries to receive interest-rate subsidies, including steel, which was the largest recipient of the interest-rate subsidy. Both private and state-owned steel companies continue to have access to low-cost funds from state-owned banks that have a strong incentive to lend to a “designated industry” such as steel. Another area of concern is the Chinese Government’s intervention in the domestic price-setting mechanism. This interference has caused steel prices in China to fluctuate widely in a manner that does not accord with market economics.

China, the world’s largest steel producing and consuming nation, has the potential to be the most disruptive force in world trade in steel and many other products going forward. Therefore, the extent to which China is—or is not—playing fairly by the rules is of extreme importance to steel and other U.S. industries.

China and the OECD Steel Negotiation

Negotiations are currently underway in the OECD to conclude a multilateral Steel Subsidies Agreement ("SSA"). An SSA would establish multilateral disciplines on steel subsidies, which would augment those in the existing WTO agreements. In these negotiations, China has insisted that it be relieved of some of its WTO obligations as the "price" of Chinese accession to the SSA. This is totally unacceptable and politically unthinkable. With an annual trade surplus approaching $140 billion with the U.S., China is in no need of further preferential treatment—either in the WTO or in the SSA.

Specifically, the government of China has insisted that the Chinese steel industry be: (1) granted "market economy" status with regard to antidumping measures; (2) guaranteed that there will be no use of the "special safeguard" against Chinese steel products; and (3) accorded preferential treatment on subsidy discipline, given China's status as a "developing country." AISI, among other steel associations in North America, has urged total rejection of these demands.

We support the position of the U.S. and other governments that China's WTO commitments are not a subject for the SSA negotiation. This negotiation must not be used to relieve China of its WTO accession obligations. Accordingly, China should not be granted market economy status in steel antidumping cases; it should not be guaranteed that there will be no use of the "special safeguard" mechanism against Chinese steel products; and it should also not be accorded status as a "developing country," and given preferential treatment of any kind in the SSA. Chinese measures constitute some of the most significant current market distortions in the global steel industry. They require additional discipline, not preferential treatment.

It is essential that China comply with its WTO commitments and eliminate its direct and indirect subsidies to steel. At a time when China and its steel industry are already deriving a major artificial competitive advantage from having a significantly undervalued currency, the focus of OECD discussions with regard to China should be on ensuring that China takes no action that contributes to global excess steel capacity.

Actions that should be avoided include permitting steel cartel activities that insulate the Chinese market and have the effect of subsidizing China's steel industry.

China and WTO Compliance

AISI and its North American members believe that China must:

- Comply fully with all of its WTO commitments;
- Stop its illegal and unfair currency manipulation;
- Eliminate its targeted export incentive programs;
- End direct and indirect subsidies to steel and other "strategic" industries;
- Open its markets fully to imports of manufactures.

At the same time, the United States and other WTO members must:

1. Retain an unchallenged right to apply nonmarket economy antidumping methodology until steel and other key sectors of the economy in China are no longer under government regulation or control;
2. Maintain an unchallenged right to apply "special safeguards" to injurious import surges from China;
3. Monitor very carefully China's WTO commitments with regard to its stated intention to eliminate quantitative restrictions, limitations on "trading rights" and other trade-distorting practices.

China and WTO-Authorized Trade Remedies

China continues to implement an array of market-distorting practices that may require action by the U.S. government pursuant to WTO-authorized trade remedies. For example: (1) the Chinese Government continues to promote exports of steel and other manufactures through targeted tax rebates and other incentives; and (2) the government of China continues to funnel massive government subsidies into targeted industries such as steel, which it deems to be "strategically important."

In cases where these and other Chinese measures cause or threaten to cause injury to U.S. industry, the government of the United States should apply remedial measures authorized under the WTO. These include antidumping and countervailing duties, as well as the anti-surge measures set forth in the terms of China's accession to the WTO.

Given its current nonmarket economy status for purposes of U.S. trade law, the Commerce Department at this time is not allowing Chinese subsidies to be offset pursuant to U.S. countervailing duty law. Until such time as Chinese subsidies are countervailable under U.S. trade law, the U.S. government must utilize the non-market economy provisions of U.S. antidumping law to offset such injurious effects as may occur from imports of Chinese steel into the U.S. market.

Resort to the anti-surge mechanism established under the terms of China's accession to the WTO may be necessary should other U.S. trade remedies prove inadequate to offset fully the adverse effects of market-distorting practices in China.

The disciplines established through the WTO, however, can only be fully effective with a properly functioning system of dispute resolution. Unfortunately, the flaws and weaknesses that characterize the current dispute settlement system further diminish the prospect that China's market-distorting measures will be subject to effective discipline.

Recent panel decisions on the application of trade remedies have exceeded agreed upon WTO standards and limits on panelists' authority, a trend that is weakening agreed disciplines on subsidies and other market-distorting practices. The dispute resolution process is insufficiently transparent and excludes participation by adversely affected private parties. The panel selection process is in urgent need of reform. A complete overhaul of the WTO dispute resolution process is a prerequisite to the establishment of adequate disciplines on market-distorting practices in China and elsewhere.

China and Currency Manipulation

We disagree strongly with the latest Department of Treasury report that, through a very tight reading of current law, fails to identify China or any other country as manipulating its currency. Whether it is the pegging of a currency to the dollar (by China) or extensive government intervention in exchange markets (by Japan, South Korea, Taiwan), currency manipulation by foreign governments is real—and it is a major problem for U.S. industry.

China continues to keep its currency pegged to the U.S. dollar at the rate that existed in 1995—undervalued by as much as 40 percent. The pegging of China's currency to the dollar is, in effect, a form of currency manipulation. It has been devastating to steel and its manufacturing customers in North America. The pegging of China's currency to the U.S. dollar at an unrealistic and very weak rate (and thus, the record buildup of Chinese foreign reserves) has been a key contributor to the crisis in U.S. and North American manufacturing. This is a serious irritant in the United States-China trade relationship. The solution is a significant revaluation of the yuan—and thereafter, to allow it to float.

Unsound currency relationships, such as the one that exists between the yuan and the dollar, are having a major impact on steel's ability to compete directly or indirectly, in the global marketplace. The domestic customers of the steel industry are facing this and other long-term structural challenges. They are experiencing damaging negative trends, such as increasing imports and decreasing exports, that have nothing to do with the steel—or with the President's steel tariffs. Many of steel's domestic customers are deciding they can no longer compete by producing in the U.S. and North America. They are moving production facilities offshore—especially to China. There, steel prices are higher and the steel distribution system is inefficient—but labor and environmental costs are much lower, and producers who want to export get a further "subsidy" from the significantly undervalued Chinese currency.

As the pressure from OEMs in China increases, it is forcing more and more U.S. and North American manufacturers to join the exodus just to survive. This trend of the "disappearing customer" is having a serious negative impact on the steel industry in the United States and North America. It is a longer-term threat to steel demand in North America, and to the prosperity of North America's economy and living standards. What the Congress should be concerned about is that—unless this negative trend is reversed—it will be more difficult in the future to resolve difficult social problems in the United States, including our serious retirement and health care issues.

It will also be more difficult to effect further trade liberalization. When offshore governments manipulate their currencies or engage in competitive currency depreciations to enhance their export competitiveness, it impairs significantly the benefits to steel and other U.S. and North American manufacturers from new initiatives to liberalize trade. Government manipulation of exchange rates and large or sudden changes in currency values have a far greater impact on trade flows than do technical provisions in agreements to liberalize trade. We have asked our government negotiators to keep this important factor in mind.

The practice of currency manipulation is especially worrisome when it forces other countries to undervalue their currencies in order to keep their own economies export-competitive. This chain reaction, which starts with China, is a major problem for U.S. manufacturers, including steel. Because exchange rate manipulation by Asian governments has had a devastating impact on the U.S. and North American manufacturing base—and since China is "the linchpin"—AISI is a member of the "Fair Currency Alliance." We support the effort to prepare and file a Section 301 case against China to address the unfair competitive advantage that China is deriving—and damage that its currency manipulation is doing across diverse sectors of the U.S. economy.

In addition, AISI is supporting numerous bills and resolutions on this issue. These include: the recently passed H. Res. 414, sponsored by Rep. Phil English (R–PA), which the House approved 411–1; HCR 285, sponsored by Rep. Donald Manzullo (R–IL); HR 2989, sponsored by Rep. Ernest Istook (R–OK); and HR 3058, sponsored by Rep. English.

Conclusions

No one knows how to compete with a China that can sell finished goods in the U.S. and other export markets for less than the cost of the raw materials. However, China's competitive advantages are not all "genuine." Subsidies, cartels, currency manipulation and other illegal and unfair practices play a role. There is not one single policy change that will solve our manufacturing crisis. Rather, we need a range of bold and innovative public policies—including a much more aggressive policy on trade.

The President imposed steel tariffs under Section 201 of U.S. trade law a little more than 19 months ago. He took this bold action, because he recognized that market forces—and a level international playing field—did not exist for steel. The Administration has recently expressed a renewed commitment to ensure a level international playing field for all U.S. manufacturers. It has said that it intends to make sure that China fulfills its WTO commitments and plays by the rules. It has announced the establishment of an "Unfair Trade Practices Team" at the Department of Commerce. The way to send a clear message to China and other mercantilist states that the United States is truly committed to a level playing field for U.S. manufacturing would be keep the President's steel tariffs completely intact for the full, intended three-year term.

Steel remains at the cutting edge when it comes to understanding United States-China economic relations. The opponents of the President's Steel Program have cited the President's steel tariffs as a reason why U.S. manufacturers are moving operations to China. This is false on its face. Steel prices and the President's steel tariffs have nothing to do with the flight of U.S. manufacturing to China—because steel prices are higher, and steel quality is lower, there. This is a time to understand what is really going on, and why. It is not the time to make steel or any other industry a scapegoat.

We need to confront the real challenges facing U.S. manufacturers. Unless current trends can be reversed, the name of the game will continue to be, "If you can't beat them, join them." In this regard, the recent announcements of North American vehicle manufacturers that they would like to see substantial auto parts production in China—notwithstanding the higher steel prices there—should serve as a wake-up call to all.

AISI appreciates the opportunity to provide this written submission to the Ways and Means Committee on an issue of critical importance to America's steel industry.

Statement of Carus Chemical Company, Peru, Illinois

Introduction

Carus Chemical Company ("Carus") of Peru, Illinois is a small family-owned company founded in 1915. Carus has 205 U.S. employees. Carus is the only remaining U.S. producer of potassium permanganate, a chemical that has important applications, including drinking water and wastewater treatment, and contaminated site clean-up.

Carus is the world's most efficient and environmentally responsible producer of potassium permanganate due to our economies of scale and patented process improvements. For over 50 years, we have continually worked to refine our process, to improve our utilization of key chemical inputs, to enhance our energy efficiency, and to reduce our impact on the environment. As a result of these efforts, our production process meets and exceeds all applicable U.S. environmental standards. In contrast, other producers, specifically those in China, still use an inefficient, energy-intensive and environmentally damaging process dating from well before the 1970s.

Carus and its employees have very serious concerns about the unwillingness of Chinese enterprises to abide by existing international trade rules, particularly rules against the dumping of products. Our experience in recent years has repeatedly demonstrated that some Chinese enterprises simply do not take these rules seriously and will do whatever they can—including making up data, forging documents and seriously misleading U.S. authorities—in an effort to evade the antidumping laws. We also have broader policy concerns about the inability of existing U.S. trade laws and trade policies to prevent the continuing erosion of our U.S. manufacturing base. In particular, we are dismayed at continued reports that modern, efficient and environmentally sensitive facilities that provide good jobs to U.S. workers are being forced to give way to inefficient and environmentally damaging Chinese plants operated by enterprises that have little regard for their workers or for rules of fair trade.

Conduct of Chinese Enterprises in Dumping Cases

Since 1983, the United States has had in place an antidumping duty order against unfairly priced potassium permanganate from China. The dumping order was and is necessary because Chinese firms continue to sell potassium permanganate on the world market at prices that are below the market economy cost of raw material and energy inputs.

In recent annual reviews of the dumping order, dishonest Chinese enterprises, aided by equally unscrupulous U.S. parties, have aggressively sought to eliminate the dumping duty on their potassium permanganate imports. These parties have used a variety of fraudulent, illegal and abusive tactics—including the forging of key Chinese documents, fraud on U.S. Government investigators and violations of important U.S. laws and regulations. Our experience has included the following appalling examples:

1. The annual review for 1999 of Chinese producer Zunyi Chemical Factory involved a single test shipment to U.S. importer Wego Chemical. This shipment was *smuggled* into the US from China in a shipping container and falsely labeled "tools and toys." Because potassium permanganate is a hazardous oxidizer, this violated numerous U.S. laws and regulations on the import and transport of hazardous materials into the United States. It also placed the container ship and its crew in considerable danger. (It is of note that potassium permanganate is a potentially incendiary substance that has been found in the homes of the Unibomber as well as terrorists in Frankfurt, Germany. It is also a precursor chemical controlled by the Drug Enforcement Administration ("DEA") that can be used for cocaine production.) Despite this illegal conduct, Commerce Department rules and practice allowed the case to be continued and awarded a lower margin for Zunyi with no apparent consequences for this illegal conduct.
2. In the new shipper review for 2000, the Commerce Department conducted a 16-month review of the Chinese producer Groupstars. This included a two-week on-site verification at Groupstars' multiple sites in China. Carus raised a number of serious concerns about Groupstars, but the Commerce Department was unable to uncover supporting evidence at verification. Later on, however, the Commerce Department dismissed the review when Carus, after extensive and costly participation in the review, proved that Groupstars had forged a key business license and had thus lacked standing to request the new shipper review in the first place. Other than the dismissal of the review, Groupstars has apparently suffered no consequences for this outright fraud, while Carus incurred over $250,000 in legal costs. Since the dismissal of the 2000 review, even more outrageous information has surfaced about Groupstars' conduct in that review. Groupstars' U.S.-based officials have since admitted in certified statements to the Commerce Department that they *"made up"* their key claims in the 2000 review and even lied about the actual producer. The record also shows that Groupstars falsified accounting documents and production records to back up these false claims and certified to the Commerce Department that these documents and records were bona fide. All of this, in turn, means that the Commerce Department spent some two weeks traveling to and verifying Chinese plants that had *absolutely nothing to do with Groupstars' actual 2000 production.* Last year, Congressman Jerry Weller asked the Commerce Department Inspector General to look into this clear evidence of extensive fraud on the U.S. Government. We also encourage the Committee to review the record of this appalling case.

3. Given the absence of any consequences arising from this fraud and the apparent absence of any meaningful deterrents, Groupstars sought another review for 2001. In that review, Groupstars continued to make false and misleading statements to the Commerce Department. For example, Groupstars and its lawyers submitted copies of sensitive Indian company internal documents, which they certified were obtained from the public record of a trade case in India. However, the Indian company protested and informed the Commerce Department in writing that these documents were company confidential and believed to be stolen. Groupstars also certified usage data that was impossible for its production process. In addition, the record of the review was filled with evidence of false and misleading financial and accounting practices and collusion with producers and claimed customers. Although the Commerce Department eventually ruled against Groupstars in the 2001 review, it did so only after affording Groupstars numerous opportunities to correct false and misleading information and only after Carus was required, at considerable expense, to demonstrate that Groupstars' technical, financial and sales information was not credible.
4. Under its current regulations, the Commerce Department apparently has no direct authority to levy administrative sanctions against parties that are willing to falsify required certifications and engage in other fraud and fabrication to evade dumping duties. These illegal activities waste the limited financial and human resources of the Commerce Department and impose unnecessary costs on U.S. taxpayers. Such fraudulent behavior has also cost Carus, a small company, over $550,000 since early 2000. Had we not devoted considerable effort and expense to uncovering this misconduct, Carus could well have been put out of business, with the direct loss of over 200 U.S. jobs and the loss of other jobs in our Illinois Valley region and throughout the United States.

These repeated and serious abuses show that Chinese enterprises simply do not take our dumping laws seriously. Carus does not believe that our experience in this regard is unique—we understand that other U.S. manufacturers and producers have faced similar misconduct in other trade cases involving China. We have also seen recent press reports detailing outrageous abuses of the Commerce Department's verification process by unscrupulous enterprises in China.

All of the above points to the need to make changes in the dumping laws and how they are administered, particularly in certain China cases. Among other things:

1. In the current economic and political environment in China, some dishonest Chinese enterprises and their U.S. importers have strong incentives to engage in fraud and deception in U.S. dumping cases. Standard Commerce Department investigation and verification techniques apparently are not always sufficient to address the serious threats posed to U.S. producers by these unscrupulous parties. Carus appreciates the difficult task facing the Department of Commerce and its employees in investigating Chinese parties who are intent on eliminating current dumping duties through dishonest and abusive conduct. Carus is concerned, however, that the Commerce Department may not always have the resources and legal, regulatory, and other powers that it needs to address this conduct. Congress and the Commerce Department need to tighten policies and practices to assure that dishonest and suspicious parties are more thoroughly investigated and that the Commerce Department's investigators have all appropriate resources, including specialized expertise in Chinese financial, business, technical and legal matters. Additionally, Congress and the Commerce Department should consider steps to provide greater assurance that Chinese information and record-keeping systems are legitimate and reliable (e.g., by insisting on audited and certified financial information as is required of firms in the United States).
2. Commerce Department policies and procedures should ensure that fraud or other illegal conduct uncovered during the course of dumping investigations is actively investigated and, where appropriate, referred for prosecution. The prosecution of those responsible for defrauding the U.S. Government in trade cases could be a powerful deterrent to future fraud. Additionally, it is important to examine whether changes in applicable law or regulations are necessary to help the Commerce Department combat such conduct, particularly if a firm engages in the repeated submission of false certifications and other abusive conduct on a repeated basis. For example, Congress and the Commerce Department should seriously consider the establishment of a specialized office to investigate serious fraud allegations in dumping cases. In addition, Congress should also consider authorizing the Commerce Department to impose administrative sanctions on parties and/or counsel that repeatedly file and certify false

information. Without meaningful deterrents, dishonest exporters and importers will not take our dumping laws seriously. In particular, unscrupulous Chinese enterprises and related U.S. parties will continue to have every incentive to seek low duties by repeatedly filing and certifying false and misleading information with the Commerce Department.

3. Chinese exporters and their U.S. allies are increasingly "gaming the system" in their efforts to eliminate current dumping duties. For example, in our cases, Carus has seen the abusive filing of a new shipper review to obtain a zero cash deposit. This review request was based on highly questionable domestic sales to U.S. purchasers and on business licenses that were ultimately shown to be forged. Congress and the Commerce Department should undertake a systematic review of longstanding policies and practices in non-market cases to determine if changes are required to address this increased "gaming" by Chinese entities.
4. The Chinese Government should also bear some responsibility for conduct of Chinese enterprises in U.S. dumping cases. China benefits greatly from the current $120 billion imbalance in trade with the United States and has repeatedly touted the significance of its membership in the World Trade Organization. If China wishes to be a responsible member of the World trading community, it should take steps to address fraud and other serious misconduct by corrupt Chinese enterprises in the dumping process. Among other things, the United States should seek commitments from China to enforce China's own laws against Chinese enterprises that are shown to have engaged in such serious misconduct as forging official business documents and falsifying financial information.

China's Continuing Threats to U.S. Manufacturing

In addition to our specific concerns about the Administration and enforcement of U.S. dumping laws against deceptive Chinese enterprises, we are also disturbed by the overall course and direction of the U.S. trading relationship with China and the continued threats posed by China to the U.S. manufacturing sector. In instance after instance, highly efficient U.S. businesses that provide good jobs to American workers and operate in an environmentally responsible manner are being threatened and marginalized by dirty and inefficient Chinese operations run by Chinese enterprises that have little or no concern for the health and well-being of their workers or the environment of the surrounding communities. This trend is of particular concern to the U.S. manufacturing and chemical sectors. Although Carus has so far been able to fend off attacks against the current antidumping duty order for permanganate, neither we nor most other U.S. producers can afford to defend against a continuous onslaught by unscrupulous Chinese enterprises. This already difficult and prohibitively expensive task is made even more difficult when such enterprises are aided by China's currency policy and by the Chinese Government's inability or unwillingness to effectively enforce even basic environmental, safety, and labor standards.

The U.S. Government must act to confront the serious threat that China poses to the U.S. manufacturing sector. Among other things, the United States must seek to prevent abuses by Chinese enterprises by aggressively enforcing all of our own laws, including laws on matters such as the shipment of hazardous chemicals and the safety of imported products. (In the specific case of potassium permanganate this requires continued vigilance by the DEA of China's international sales of this important precursor chemical.) Moreover, the United States must press China to better enforce its own substantial body of enterprise laws and environmental, health, and labor laws to assure that Chinese exporters do not gain unfair trade advantages by engaging in conduct that is illegal in China itself. Finally, the United States should give serious consideration to revamping international trade rules and/or U.S. laws and practices to address these kinds of abuse. For example, it might be appropriate to include some limited form of environmental, health, and safety cost in the calculation of normal value in dumping cases where enterprises attempt to gain unfair advantages in trade by violating by applicable national law or other requirements. Alternatively, Congress should consider expressly authorizing the application of the countervailing duty laws to China and encouraging the Department of Commerce to investigate whether selective waivers from or the selective enforcement of China's environmental, safety or labor laws may constitute a countervailable subsidy in specific cases.

Carus urges Congress and the Administration to take aggressive steps to address concerns raised by imports from China. These steps should address particular problems that we and others are facing under the dumping laws as well as key overriding issues in the U.S.-China trade relationship. This is no mere academic exercise. Rather, the fate of many competitive and efficient U.S. businesses hangs in the balance. In the case of Carus, the continued survival of our company, the jobs of our 205 U.S. employees and the economy of the Illinois Valley region all critically depend on how Congress and the Administration respond to these important concerns.

Carus is a strong proponent of free and fair trade. However, U.S. trade policy with China must be based on the principle of *fraud-free* trade and on responsible conduct by China and Chinese enterprises. Carus and our employees thank the Ways & Means Committee for the opportunity to highlight these critical issues.

Statement of Daniel T. Griswold, Cato Institute

There is no minimizing the fact that the last three years have been brutal for U.S. manufacturing. Output is only now slowly recovering from its plunge in 2001, and 2.7 million fewer Americans work in factories today than three years ago. The real debate is about why we've suffered this slump in manufacturing output and employment, whether the cause is trade with China or other factors closer to home, and what if anything Congress can and should do about it.

First, some perspective: American manufacturing is not about to disappear. We are not "deindustrializing" or "losing our manufacturing base." Our nation remains a global manufacturing power. Despite the recent slump, manufacturing output is still up 40 percent from a decade ago, according to the Federal Reserve Board's monthly index of manufacturing activity. Manufacturing output today is double what it was in the early 1970s and triple what it was in the 1960s. Figure 1 shows the growth in U.S. manufacturing output since the mid-1980s. As you can see, manufacturing output actually accelerated after implementation of NAFTA and the Uruguay Round Agreements in the mid-1990s. In fact, U.S. industry added a net half million manufacturing jobs in the five years after NAFTA. American companies are world leaders in hundreds of sophisticated products, and they run neck and neck with German companies as the world's leading exporters of manufactured goods. This is not the profile of a nation losing its industrial base.

Second, trade with China or the rest of the world is not to blame for the manufacturing recession and loss of jobs. The problem is not too much trade but not enough domestic demand and growth, especially investment and business spending. What put the kibosh on U.S. manufacturing was the dot-com meltdown, slumping business investment, lingering uncertainty from the war on terrorism, corporate scandals, and slow growth abroad. Critics of trade are quick to blame imports, but the real story is that import growth has been negative or sluggish during the last three years. Only now are monthly import numbers finally recovering to their previous levels of pre-recession 2000.

Conventional wisdom would tell us that more imports mean less domestic output. Every widget we import means one less widget made and fewer widget workers employed, or so we are told. But for manufacturing as a whole, the reality is quite the opposite. Figure 2 shows the growth of manufacturing imports to the United States and U.S. domestic manufacturing output for each year since 1988. As you can see, in those years where manufacturing imports grew the fastest, so did domestic manufacturing output. In the booming 1990s, when manufacturing output was growing the fastest, manufacturing imports were surging by double digits. In 2001, when manufacturing output fell, so did manufacturing imports. We seem to either enjoy years of strong growth in imports and output or endure years of weak growth in imports and output.

The reason is straightforward. Imports and output both rise and fall with domestic growth and demand. An expanding economy creates demand for both domestic production and imports. And as U.S. companies expand production, they import more intermediate goods for assembly and capital machinery to make their plants more efficient. The positive connection between imports and output exposes the protectionist mirage that raising new barriers to imports will somehow promote domestic output. That mirage rests on the false assumption that if we can just reduce imports, through tariffs and currency adjustments, we can make those widgets ourselves and employ more workers. But a combination of falling imports and rising domestic production does not appear to be a realistic option. In our economy today, trade and prosperity are a package deal. When we prosper, we trade; when we trade, we prosper.

Why have so many manufacturing jobs been lost in the past three years? Two reasons stand out: A cyclical downturn in the economy reduced demand for manufactured goods, and amazing advances in worker productivity have allowed American companies to produce more goods with fewer workers. American factories are using the Internet, just-in-time inventory, and new technologies—all spurred by international competition—to raise worker productivity. American factories are producing three times the volume of manufactured goods they did in the mid-1960s with fewer workers because today's workers are three times more productive. And we all know that productivity growth is the only long-term foundation for rising prosperity.

Despite those underlying realities, China has become the focus of economic anxiety, just as Japan was 15 years ago. Imports from China do compete with products made by certain U.S. factories and they do displace a relatively small number of U.S. workers. Along with the dislocation it causes, trade with China delivers huge benefits to the U.S. economy. First and most important, American families benefit as consumers. China is a leading supplier of imported clothing, shoes, furniture, toys, sporting goods, and consumer electronics. Those are products poor and middle-class families commonly buy at a discount store, where Chinese imports keep prices down and raise the real wages of American workers. American producers also benefit from the lower-cost inputs from China, such as machine parts, office machines, and plastic moldings. Those inputs allow American-based manufacturers to retain their competitive edge in global markets.

Imports from China have indeed grown rapidly in recent years, but they are nothing like a flood. In 2002, Americans bought $125 billion worth of goods made in China—10 percent of our total imports and a small fraction of our $10.4 trillion economy. There is nothing alarming about Americans spending about one penny of every dollar of our income on products made by the one-fifth of mankind that lives in Mainland China.

There has been no wholesale movement of U.S. factories and investment moving across the Pacific to China. If the critics were right, U.S. multinationals would be falling over themselves to relocate capacity to China to take advantage of its low wages. In reality, U.S. investment in China has been stable and modest. According to figures compiled by the Bureau of Economic Analysis at the U.S. Commerce Department, from 1999 through 2002, American manufacturers directly invested an annual average of $1.2 billion in Mainland China, and that figure has not been going up. In fact, it went down last year to about $500 million.

That modest investment in China compares to an annual average of $16 billion in outward U.S. direct manufacturing investment in the European Union during that same period, $3.8 billion of that in the Netherlands alone. In other words, American companies invest three times more each year in manufacturing in the tiny Netherlands, population 16 million, than they invest in all of China. Our manufacturing investment in China is less than 1 percent of the $200 billion invested each year in America's domestic manufacturing capacity. And it is overwhelmed by the average net inflow of $20 billion in foreign direct manufacturing investment to the United States each year.

If low wages drive U.S. manufacturing investment to go abroad, then why does the large majority of outward investment go to other high-wage, high-standard countries? Most of our outward FDI flows to other rich countries because wages account for a relatively small share of the cost of production. Other considerations for investing are the size of local markets, skills and education levels of workers, political and economic stability, the rule of law, and the reliability of the infrastructure. As many American companies can attest, investing profitably in China and other developing countries remains a challenge—because of their underdeveloped infrastructure and legal systems, undereducated workforces, remaining trade barriers, and limited consumer markets.

That leads to my final point: How can we hope to see hundreds of millions of people in China and India become middle-class consumers of U.S. products if we do not allow them to participate in the global economy?

Critics of trade with China ignore the country's growing appetite for consumption and imports. While China is the world's fourth leading exporter, it is also the world's sixth leading importer. It has become the engine of demand growth in East Asia. It is rapidly becoming one of the world's top markets for automobiles. And China has now displaced the United States as the world's top importer of steel. In fact, by soaking up global steel supplies and lifting global steel prices, China has become the U.S. steel industry's best friend. While America's total exports to the rest of the world were falling in 2002, our exports to China rose 14 percent.

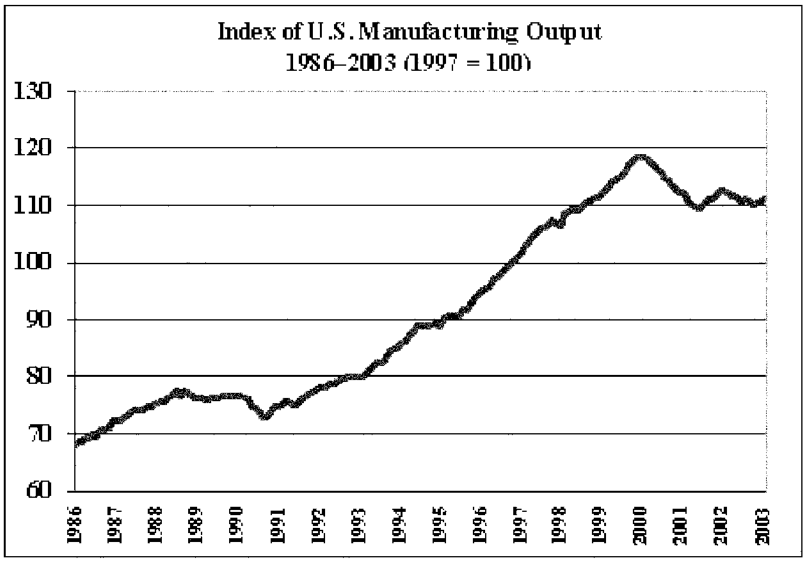
And what do the people and government of China do with all those dollars they earn from exports to the United States but do not spend buying our goods and services—the infamous bilateral trade deficit? They invest those dollars in the United States, typically in U.S. Treasury notes. That investment helps finance the U.S. federal budget deficit, keeping domestic interest rates lower than they would be otherwise and freeing private U.S. savings for investment in the private sector. So our trade with China is blessing us three times over, through low-cost imports, through rising demand for our exports, and through capital inflows that keep our domestic interest rates low. It is truly a win-win-win relationship for the United States.

For all those reasons, imposing tariffs on Chinese goods in the name of helping U.S. manufacturing would be a disaster. It would be a direct tax on American working families, especially those on modest incomes. It would drive up costs for U.S. companies that depend on parts, supplies, and other goods from China to remain competitive in global markets. It would reduce demand for U.S. exports and for U.S. Treasury bills, depressing domestic production and driving up interest rates. Equally important, punitive tariffs aimed at China would sour U.S. relations with an important country in an important part of the world as we try to wrestle with global terrorism and North Korea's nuclear ambitions.

Pressuring China to readjust or float its currency poses dangers of its own. China's currency has been pegged to the dollar for a decade now. When the dollar appreciated relentlessly in the 1990s, so did the Chinese yuan. When other Asian currencies plummeted in value during the financial crisis in 1997–98, the yuan stayed fixed to the dollar. As the dollar has gradually depreciated since early 2002, so too has the yuan. Just about everybody, including the Chinese Government, expects China to eventually adopt a floating currency and open its capital market just as virtually all advanced nations have done. But China's banking system is a mess and its capital controls keep hundreds of billions of dollars worth of domestic savings effectively trapped inside the country. If China were to move too rapidly toward free capital flows and a floating currency, it could precipitate a collapse of its banking system, the flight of billions in savings, and a rapid depreciation of its currency. We could soon regret getting what we asked for.

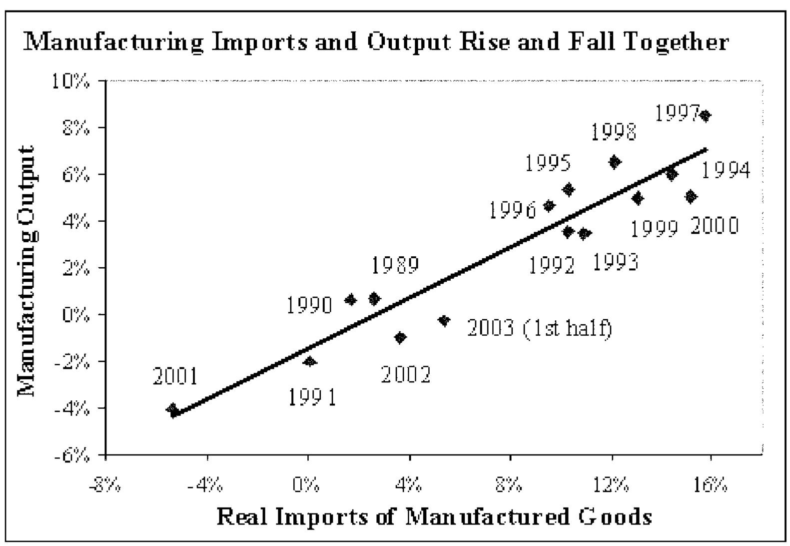
If Congress and the Bush administration want to help U.S. manufacturing, they should focus their efforts on promoting a more robust economy and renewed confidence in the business sector. Declaring war on imports will only hurt American families, producers, and the overall economy at the expense, not the salvation, of manufacturing and jobs.

Figure 1.



Source: U.S. Federal Reserve Board.

Figure 2.



Sources: Bureau of Economic Research; Federal Reserve Board

Statement of the Customs Bond Committee of the American Surety Association

The Customs Bond Committee of the American Surety Association ("ASA") appreciates the opportunity to submit this testimony for the record in connection with the Ways and Means Committee Hearing on United States—China Economic Relations and China's Role in the Global Economy.

The American Surety Association is a trade association comprised of insurance companies, and their agents, authorized by the Department of Treasury to guarantee US government obligations. A standing committee of ASA is the Customs Bond Committee. members of the committee represent surety companies that underwrite over 70% of all surety bonds currently on file with the Bureau of Customs and Border Protection ("Customs"). Members maintain offices throughout the country, principally in major port cities. Through the customs bonds they underwrite, ASA members ensure that importers—including importers of Chinese products—honor their legal responsibilities.

The issue we would like to raise with the Committee has to do with fraudulent Chinese imports into the United States, and how various illegal schemes are employed to avoid antidumping duties that are in place on agricultural products. These schemes undermine the effectiveness of antidumping laws to protect injured US domestic industries targeted by the fraudulent imports, and coincidentally, jeopardize the availability of surety bonds for legitimate Chinese trade, and perhaps for a broader spectrum of United States trade.

Antidumping duties are a statutory mechanism to increase the cost of selling a foreign product in the US marketplace that was originally sold for export to the US at a price less than the product is sold in the domestic market of the exporting country (*i.e.*, at a price less than the "fair market value" or "normal value" in a non-market economy). If foreign sales for export at less than "fair" or "normal" value result in economic injury to a US industry, then antidumping duties are assessed to "level the playing field."

For more than two centuries the US government has required importers to post security in one form or another to facilitate the import process while providing sound assurances of compliance with all import laws, and especially, to assure the collection of proper duties, taxes and fees when the final assessment is made by Customs. In lieu of depositing cash with Customs and restricting valuable working capital, importers in virtually all cases use corporate surety bonds ("customs bonds") to meet their statutory security requirements. Because of the security provided by the bonds, imports are released to the importer by Customs soon after arrival and avoid unnecessary port congestion and delay. Importers file the necessary paperwork and pay estimated duties within 10 business days after the merchandise is released from Customs.

Surety bonds are a unique form of security. A surety bond is a contract between three parties: the principal, who is the party that undertakes an obligation, the surety, who guarantees the principal will perform the obligation, and the obligee, who obtains the benefit of the bond. In the case of customs bonds, the importer is the principal, and the obligee is the United States. In the event a bonded importer fails to perform its obligations to Customs, Customs will seek performance from the surety. The surety will seek indemnification from the importer for any expense it incurs in performing its obligations under its bond. Surety companies do not willingly provide bonds to importers who they believe will not perform all their bonded obligations, unless they takes steps to protect their exposure in advance, generally by holding collateral, such as a bank letter of credit or taking a deposit of cash.

For the added creditworthiness and qualification a surety provides to the principal and to the benefit of the obligee, the surety collects a nominal premium from the principal. Because the overwhelming majority of customs bonds are not backed by collateral, importers find customs bonds to be an attractive means of fulfilling statutory requirements with minimal impact on the their limited working capital. The historically low loss activity has resulted in this combination of favorable and non-restrictive pricing and underwriting standards that importers find favorable. What we will present to you in our testimony could lead to situations that greatly restrict the surety industry's capacity to provide customs bonds to the importing public at low cost or for all types of importations.

Because of increased export activity and the non-market nature of China, Chinese exports to the US are the subject of numerous investigations into unfair trade practices; most notable are the antidumping investigations. Many products subject to antidumping investigations have antidumping duty rates that greatly exceed the actual entered value of the product (*i.e.,* in excess of 100% of entered value). When the antidumping duty cash deposit requirement approaches or exceeds the entered value, Chinese shippers and importers are more likely to develop schemes to avoid the requirement of making these substantial cash payments.

Within the last year, ASA members have uncovered two fraudulent import schemes used to avoid the requirement to make a cash deposit of antidumping duties on certain Chinese agricultural products: abuse of the "new shipper" rules and forging documents to falsely identify the shipper or manufacturer. Following the discovery of this fraud, many if not all of the major US surety companies have chosen not to knowingly underwrite antidumping duties for garlic, crawfish, mushrooms, or honey from China. This discovery forebodes crippling losses for the US surety industry, continued unfair competition to the US industries sought to be protected by the antidumping laws, and the closure of markets to Chinese agricultural industry *vis a vis* the refusal of the US surety industry to underwrite customs bonds for Chinese agricultural products. All parties will continue to lose greatly unless the US surety industry, Customs, the International Trade Administration of the Department of Commerce ("ITA") and Congress, work together to close the loopholes in the antidumping laws that allow the fraud to continue.

(1) Abuse of the "New Shipper" rules. The first scheme involves a Chinese shipper (exporter) subject to a high antidumping duty deposit rate. Such an exporter may set up a "new" shell company in China to act as a new shipper, and in some cases, also a shell company in the US to act as the importer. This "new" shipper seeks a "New Shipper" status from the ITA. He ships a few orders to the US market as a "New Shipper" and requests the ITA to undertake a "New Shipper Review" of his export sales price.

The undertaking of a "New Shipper Review" qualifies the importer for the privilege of posting a bond in lieu of making a cash deposit of the high antidumping duty rate. This bonding privilege continues while the detailed investigation proceeds. In the interim, this "new" shipper then ships a large volume of product. At the same time, other shippers may attempt to "counterfeit" the "new shippers" identity by submitting counterfeit invoices in order to take advantage of the bonding privileges. While ITA investigates, the customs bonds secure the estimated antidumping duties on the shipments.

Under this process, shippers or importers can operate for about 9–12 months and avoid the requirement of posting a high cash antidumping duty deposit at the "PRC-Wide Rate" (376.67% for garlic; 223.01% for crawfish; 198.63% for mushrooms; and 183.80% for honey). When the ITA finishes its investigation, it publishes its Final Results of the New Shipper Review. These results are formed after the ITA reviews the sales for export and import activity over the period. If the "New Shipper" cannot substantiate that it qualifies for a lower antidumping duty adjustment ("rate") than the "PRC-Wide" rate, ITA will assess and instruct Customs to collect the "PRC-Wide" rate" on all the previous entry transactions from this new shipper. Subsequently, the shipper or importer, or both, "disappear" never having had any intention of paying the antidumping duty increases. Many times there is a revenue shortfall inadequately secured by surety bonds and cash deposits. In such cases, the government must write off uncollectible debt. All parties lose. The US industry that sought to be protected, the US surety industry, the law-abiding Chinese shippers and the legitimate importers of Chinese products, all continue to be injured by these fraudulent trade practices. All the while, the illegal shippers and importers obviously benefit.

(2) Forging Documents. The second scheme, referenced in brief above, involves the misappropriation of the name and identity of a legitimate Chinese exporter, which has a low/zero antidumping duty margin. This can be easily accomplished with today's desktop publishing capabilities, which allow for the preparation of "counterfeit" invoices. This scheme is carried out until either the counterfeit transactions are caught by the legitimate exporter (as a result of a loss of sales in the US) or by the ITA and "Customs" when it becomes apparent that the transactions reported by the legitimate exporter to the ITA pale in comparison to the evidence of sales/imports available to Customs.

ASA members have attempted on several occasions to gain the cooperation of Customs and the ITA to target and eliminate these fraudulent schemes. Generally, the agencies have rejected our requests. For example, both of the above schemes have been utilized against exporter Huaiyang Hongda (Hongda) in the antidumping case on Chinese garlic. The impact of these illegal schemes could be minimized and curtailed in the future through the Administration of the antidumping review of the Chinese garlic for the current period under review (2001–2002). By reviewing the sales and shipments of the Chinese exporter Hongda, the ITA stands to learn more about the schemes and how to develop effective techniques to counter them. However, the ITA has rescinded its review of Hongda in the current Administrative Review. ASA recommends that the ITA reconsider its decision to rescind the Administrative Review and undertake a thorough review of this problem. Hongda's review presents the most immediate and clear "test case" for the ITA to resurrect confidence in its antidumping procedures with respect to China. In light of the schemes, overriding public interest dictates that the ITA take advantage of this opportunity and conduct a review of Hongda and other shippers of Chinese agricultural products who are, or can be identified by the surety community as, participating in or being victimized by the aforementioned schemes. A failure to fully address these issues head on by the ITA will result in the continued injury both to the domestic industry seeking protection, as well as to the US surety industry.

ASA also recommends that the United States government encourage the Chinese Government to take an active involvement in monitoring the sale and export of commodities subject to US imposed antidumping duties. Such involvement may require the implementation of a visa program for verification of producer shipments. ASA members stress their willingness to arrange and/or participate in the development of independent verification programs on the United States side among the sureties, the legitimate Chinese shippers and Customs. If appropriate measures are not taken to curtail the schemes used to circumvent antidumping duties, surety companies will face staggering losses and/or will be forced to severely restrict access to customs bonds for these commodities in this trade lane, and domestic interests will continue to suffer unchecked unfair competition. This, in turn, will severely impact United States/China trade relations as law-abiding Chinese exporters will exit the market because their import customers will cease buying in the face of the crippling levels of liquid working capital which they would unnecessarily be required to pledge to continue importing.

Thank you again for the opportunity to submit comments on this very important issue. I look forward to working with you and your staff to address these critical matters.

Statement of Tom Hopson, Five Rivers Electronic Innovations, LLC, Greeneville, Tennessee

I, Tom Hopson, am the President and CEO of Five Rivers Electronic Innovations, LLC. Five Rivers is a major U.S. manufacturer of color television sets and is the only color television manufacturer left in the United States that is American-owned. Our factory is located in Greeneville, Tennessee.

ALTHOUGH A TELEVISION MANUFACTURING INDUSTRY STILL EXISTS IN THE UNITED STATES, THOUSANDS OF MANUFACTURING JOBS IN THE U.S. HAVE BEEN LOST BECAUSE OF THE FLOOD OF IMPORTS FROM CHINA, PUTTING THE U.S. TELEVISION INDUSTRY IN JEOPARDY

Some people in the United States are under the mistaken impression that there is no television industry left in the United States. According to our estimates, however, as recently as 2002, the U.S. television industry employed approximately 10,000 to 15,000 people who were manufacturing televisions or components for televisions. In fact, many people would be surprised to learn that before 2000, more televisions were made in Tennessee than in any other state.

Like many other U.S. industries, however, manufacturing jobs in the U.S. television industry have taken a huge hit as Chinese imports have flooded the U.S. market. The surge in large-screen television imports from China over the last two years and in the most recent months is shown in the table below.

IMPORTS OF LARGE SCREEN TELEVISIONS, PROJECTION TELEVISIONS, AND HDTVS FROM CHINA 2000–Sept. 2003

(Quantity in Units)

2000	2001	2002	Jan.-Sept. 2003	% Increase 2000–2002
15,940	56,295	1,291,820	1,493,728	8004%

Our Greeneville, Tennessee plant has been making television sets since 1963. In 1997, Fiver Rivers, a privately-held company, purchased the plant from Philips. For many years, we have been proud to continue on in the tradition of Magnavox and Philips making TVs in the United States and we believe we make an excellent TV. TVs from other countries, particularly from Mexico, had played an increasing role in the U.S. market. Nevertheless, we are an extremely efficient producer and we have concentrated our efforts in a product where we were most competitive—large and very large screen televisions, usually defined as having a viewing picture of greater than 21 inches. Based on our extensive experience in this industry, we had always been able to participate in the U.S. market and make a satisfactory return.

The situation changed dramatically—for the worse—in 2001, and has continued to deteriorate. Imports of large screen TVs from China have created havoc in the U.S. marketplace. In my 24 years in the television business, I have never seen a similar or more worrisome situation.

We believe we have a highly-efficient, low-cost operation. Yet, we are finding that we are simply not able to compete with the flood of imports from China. The deterioration that has occurred in the marketplace has taken place very quickly. While we always knew that the Chinese were building substantial capacity to produce TVs, we began to really feel the impact of this substantial capacity in the U.S. marketplace during the second quarter of 2001. At that time, we began to witness first hand the flood of low-priced imports that were coming in from Asia, and China in particular. By the end of 2002, they had become the dominant force in the marketplace, driving prices lower and lower.

Of course, competition is no stranger to the U.S. television industry. Over the past thirty years, the U.S. television industry has experienced substantial competition from overseas, and has consolidated and changed ownership. But as I noted earlier, Five Rivers had been successful in competing with producers not only from the U.S. but with product from other countries, particularly Mexico. But, the nature of this newest competition from China has been different. In just the past few months, we have seen our business change from a thriving business to a struggling one. We have seen a drop in our sales, in our prices, in our production volumes and in our capacity utilization. We have had to go to a four-day work week and we have laid off workers.

Not only have manufacturing jobs been lost at Five Rivers, but other manufacturers who make TV sets and their components have experienced substantial harm as well. For example, Sharp Manufacturing Company had a television plant in Memphis, Tennessee that has now stopped making televisions altogether. Sanyo, a TV set manufacturer in Forrest City, Arkansas, has laid off hundreds of workers. Orion America, Inc. closed a TV set manufacturing plant in Olney, Illinois earlier this year. Countless other TV suppliers have also shut down operations and/or laid off workers.

As this review shows, the problems caused by Chinese imports have created havoc in the U.S. marketplace. First, the sheer volume of these imports in a short period of time causes U.S. producers to lose sales. Also, the low prices of these imports forces U.S. producers to lower their prices on all makes and models of our TVs just to stay in the business. This causes serious financial problems. As volume and prices drop, the manufacturers are forced to layoff more and more workers. The national decline in manufacturing jobs are simply a reflection of the reality facing the U.S. television manufacturing sector.

Much discussion has occurred in the press about potential changes in the TV industry, including new technologies and digital broadcasting. In the years ahead, we believe that the television industry will continue to evolve, first to digital TV capable of high definition broadcast, and then, perhaps to different, non-CRT based technologies. We want to stay in this business and must have the investments in place to stay abreast of these changes. We believe we make an excellent product that can compete fairly with any other product in the world. But, the U.S. television industry is facing the same problem that many other U.S. manufacturing industry's are facing—a flood of unfairly-traded products from China.

THE U.S. TELEVISION INDUSTRY, INCLUDING FIVE RIVERS AND TWO UNIONS, HAS SOUGHT RELIEF FROM THESE UNFAIRLY TRADED IMPORTANT THROUGH A DUMPING PETITION; EFFECTIVE AND STRONG ENFORCEMENT OF OUR U.S. TRADE LAWS IS ESSENTIAL TO ENSURING THAT U.S. MANUFACTURING JOBS STAY IN THE UNITED STATES

The U.S. television industry is now seeking relief from these unfair trading practices in an antidumping case that was filed in May of this year. The Commerce Department and the International Trade Commission are currently and diligently conducting this investigation to determine the degree to which Chinese imports are being dumped here in the United States and to assess the harm that these imports are causing. To us, the harm is self-evident. Manufacturing jobs are being lost almost on a daily basis as Chinese products flood the U.S. market. We hope that this Committee closely examines and considers all options available to it, including ensuring that U.S. trade laws remain strong. Otherwise the fate of the U.S. television industry as well as the fate of many other industries in the United States will be all too easy to predict.

I appreciate the opportunity to submit these comments.

The Heritage Foundation
Washington, DC 20002
October 20, 2003

Congressman Bill Thomas
Chairman of Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Congressman Thomas:

I am writing to express the views of The Heritage Foundation on America's economic relations with China in connection with the upcoming hearing on October 30–31 in the Ways and Means Committee on this subject.

A proposal to allow the U.S. government to impose tariffs on China if the yuan is not revalued, may appeal to workers' fears, but it makes no economic sense. It will simply harm millions of American consumers. The loss of American manufacturing jobs cannot be blamed on China. That decline has been occurring for over two decades, and reflects a shift from manufacturing to services. Many of the jobs are being lured to countries whose currencies are clearly not undervalued. The proposed tariffs will therefore only prop up uncompetitive industries and create false economic signals that will keep U.S. workers and investors from migrating to new industries where they now have the biggest impact.

I have attached a copy of a Heritage Executive Memorandum (No. 902 of October 3, 2003) entitled "Undervaluing the Damage of a Tariff" for your further reference.

Sincerely,

Michael Franc
Vice President, Government Relations

Undervaluing the Damage of a Tariff

Marc A. Miles, Ph.D., and Ana Isabel Eiras

Some Members of Congress have recently found a scapegoat for lost manufacturing jobs: the yuan, the currency of the People's Republic of China. Their proposed bill (S. 1586) would allow the U.S. government to impose a tariff on imports from China if China fails to revalue the yuan. This bill is an example of flawed economic analysis leading to bad policy. Higher tariffs on Chinese products will hurt millions of U.S. consumers and, even worse, will not address the real issue—China's strict controls on capital flows.

Instead of supporting higher tariffs, the Bush Administration should pressure China to relax controls on capital flows, allowing reserves now accruing to leave the country in search of better returns abroad. The Administration should also work with China to eliminate remaining Chinese tariffs and non-tariff barriers so that the Chinese can import more. A move toward greater economic freedom in China, not less economic freedom in the United States, will bring sustained benefits for both China and the U.S.

A Short-Sighted Tactic. While the argument for raising tariffs on Chinese products to safeguard the U.S. manufacturing sector may appeal to workers' fears, it makes no economic sense. In a recent letter to the editor in *The Wall Street Journal,* Senator Joseph Lieberman (D-CT) blamed China's manipulation of the yuan for "American manufacturing hemorrhaging jobs." That faulty statement could get votes, but a policy based on it would harm millions of American consumers and the overall health of the U.S. economy for at least three reasons:

- **China is not the cause of lost manufacturing jobs.** According to the U.S. Department of Labor, manufacturing jobs have been declining for almost two decades, but not because of increased trade with China. China is not the only country with cheaper jobs and lower manufacturing costs. Mexico, several Central American countries, and some other Asian countries also have cheaper labor and production costs than the U.S., and few would argue that this is due to an undervalued currency. The U.S. decline in manufacturing jobs is the result of increased productivity. In plain English, with new technologies the U.S. is producing more with less labor—an indication of economic health, not economic sickness.

The loss of manufacturing jobs also reflects a shift from a manufacturing-based economy to a service economy based on human capital, akin to the 19th century shift from an agricultural to a manufacturing economy. Those losing jobs in manufacturing can be trained for work in the service sector. Job creation in the services sector has increased by almost 70 percent since 1991.

In addition, the loss of manufacturing jobs reflects choices made by Americans. For the past century, manufacturers in the Northern states have complained about job migration to the South. To encourage economic development and raise living standards, Southern states generally adopted less stringent labor, pro-union, and pro-environmental regulations than their Northern neighbors, resulting in lower wages for employees and greater flexibility and potential profits for employers. Today, when developing countries are faced with a similar choice between stricter regulations or feeding people, regulations lose their attractiveness and wages remain lower. Forcing unwanted regulation on these countries may stem job migration, but only at the cost of reduced economic freedom and more hunger in developing countries.

- Trade barriers hurt the economy. Trade barriers raise the price of imports for U.S. consumers while protecting uncompetitive economic sectors. The artificially high wages in these less productive industries discourage workers from moving into more competitive sectors, such as financial services or information technology, thereby reducing the overall efficiency of the U.S. economy.
- China's exchange rate is not the problem. While many economists argue that the yuan is currently undervalued—perhaps by as much as 40 percent relative to the dollar—there is simply no clear way to know whether this is true. However, even if the yuan is undervalued, raising tariffs is certainly not the solution. This would raise the price of Chinese imports, effectively playing favorites among Americans—making certain U.S. manufacturers "winners" at the expense of millions of U.S. consumers while harming workers in industries that depend on Chinese imports. Such a policy would distort, rather than help, the U.S. economy.

What the Bush Administration Should Do. The Bush Administration should actively oppose calls by Members of Congress to raise tariffs on Chinese products. More tariffs will both compromise the health of the U.S. economy and hurt millions of consumers, workers, and producers who rely on imports. If Congress passes a law raising tariffs, President Bush should veto it.

The Administration should also work with China to remove trade and outbound investment barriers in China. Once Chinese investors have more choices, they can be encouraged to invest in the United States—at a potentially higher return—which would stimulate U.S. job creation.

Conclusion. The U.S. is trending toward a more services-oriented economy and increased productivity in the manufacturing sector. This shift will encourage U.S. workers to train for opportunities in the rising services sector. The loss in manufacturing jobs, therefore, reflects a long-term trend, not the effects of China's current exchange rate.

Imposing tariffs on Chinese products is a shortsighted policy that will not create more U.S. jobs overall but will hurt millions of U.S. consumers. To improve the economy, the Administration should instead negotiate a rapid reduction of Chinese trade tariffs. If China balks, the Administration and Congress should reassess policies on technology to China.

A move toward greater economic freedom in China, not less economic freedom in the United States, will bring sustained benefits for both China and the U.S.

—Marc A. Miles, Ph.D., is Director of, and Ana Isabel Eiras is Senior Policy Analyst for International Economics in, the Center for International Trade and Economics at The Heritage Foundation.

Statement of Leo and Jean Hunt, Naples, Florida

This statement is to notify you that we are FOR REVOKING the PERMANENT NORMAL TRADE RELATIONS FOR CHINA. We are losing too many jobs and experiencing a tremendous balance of trade deficit because of Chinese currency manipulations and PNTR.

Thank you for your consideration in this important matter.

Statement of International Mass Retail Association, Arlington, Virginia

The International Mass Retail Association (IMRA) welcomes this opportunity to present comments for the record as part of the Ways and Means Committee's hearing on U.S.-China Economic Relations and China's Role in the Global Economy.

By way of background, IMRA is the world's leading alliance of the fastest growing and most innovative retailers and their product and service suppliers. IMRA's members represent more than $1 trillion in sales annually and operate more than 100,000 stores, manufacturing facilities and distribution centers nationwide. Its member retailers and suppliers have facilities in all 50 states, as well as internationally, and employ millions of Americans.

Virtually all of IMRA's members, both retailers and suppliers, rely on international trade to conduct their businesses. Our members depend on imports for both finished consumer products and inputs to production for merchandise that will eventually be sold at retail. They also seek opportunities to expand retail outlets in countries that are open to U.S. investment and expand market access for American products.

IMRA recognizes the plight of U.S. manufacturers and hopes that this hearing will focus on the larger U.S. economic picture and actions that can productively reinvigorate the many sectors which are inherently linked through trade.

IMRA is concerned that much of the current discussion targets China for the slower pace of U.S. economic recovery in certain sectors. China is an important source of supply as well as an avenue for retail investment. We would urge Congress to carefully analyze any proposal to "correct" trade imbalances or currency exchange rates through tariffs or other forms of government intervention. Such actions in free markets will not meet the ultimate objective of raising disposable income for working American families, decreasing consumer prices and accelerating the pace of economic recovery. We believe such "corrective" actions aimed at China would have the opposite effect.

The Retail Industry Makes Markets for Manufacturers

Without retailers, wholesalers and consumers, manufacturers would have no markets. Consumers, whether retail customers or industrial users of inputs, *drive* free-market economies. The distribution industry, including IMRA's members, *makes the consumer market.*

Manufacturers are inherently linked to the industries that create and serve the markets—industries like retailing, wholesaling, warehousing, distribution, transportation, advertising and marketing. Indeed, manufacturers (especially those making consumer products) *depend* on the retail sector. And the retail sector is a powerful economic engine in the United States. Consider that:

- According to Bureau of Labor Statistics, the retail industry represents about 12% of the non-farm workforce in the United States. This exceeds the 11% of workers represented by the manufacturing sector. When the wholesale trade, transportation and warehousing sectors, which are essential to goods distribution and market creation, are taken into account, the distribution sector accounts for almost 19% of the U.S. workforce.
- It is simply a myth that service sector jobs (and distribution sector jobs specifically) are inferior to jobs in manufacturing. Indeed, the retail sector pays higher hourly wages than some manufacturing sectors. For example, according to the Bureau of Labor Statistics, average hourly wages for retail workers in September 2002 were $11.81. Textile, apparel and leather workers all earned less. The average wage for all manufacturing was $15.41, which is higher than retail wages, but wholesale and transportation wages, which are essential to goods movement and market creation outstrip manufacturing wages at $17.12 and $15.86, respectively.

Retailers are the *customers* of manufacturers. There may be many reasons a manufacturer finds it difficult to compete, and in most instances the cause cannot be attributed to unfair competition by imports. Global competition, especially as applied to foreign sources of supply, is often the scapegoat for other systemic problems in an industry, such as an industry's failure to respond to its customers' needs.

Markets are driven only in part by price. Quality, style, features and *responsiveness* equally motivate demand. When a manufacturer can no longer respond appropriately to its customers or its market, customers are forced to seek alternate sources of supply. Price may drive this change, but other factors such as transportation costs, reliability, ability to meet niche marketing demands, security concerns, responsiveness to the retailer's demands or just-in-time inventory controls are all factors that affect sourcing decisions. In a free market, the ability of consumers and customers to seek retailers and suppliers who are responsive to their ever-changing needs and demands is the key to success.

Government regulation of this relationship between a customer and the source of supply will artificially disrupt the market, adding costs and inefficiencies to the system. More importantly, such policies as protective tariffs, which are aimed at helping one small group of producers, always have negative downstream impacts on consumers and consuming industries.

For example, many of the domestic suppliers supporting action against China have relationships and interests with suppliers in Brazil, Malaysia and elsewhere outside China. Thus, any action against China will disproportionately benefit those domestic suppliers to detriment to the purchasers from China. In effect, *these policies are designed to force customers to buy from a single source, to raise prices, disrupt the orderly development of trade and to limit choice in the marketplace.*

If such policies actually worked, they might make some sense in the short term. History has shown that protectionist policies rarely achieve their intended goal and usually have the opposite effects. Government intervention in markets usually leads to many unintended consequences, such as restricting market demand and causing sourcing shifts to other countries, which drives up prices and penalizes both consumers and retailers.

It is worth noting that a manufacturer's need to respond to their markets also leads many of them to make foreign investments. An increasing number of successful U.S. manufacturers have invested heavily in large consumer markets in order to become more responsive to customer demand.

For example, according to the Bureau of Economic Analysis, the United States invested about $1.5 trillion abroad in 2002, of which $393 billion was in the manufacturing sector. Of this investment, fully $67 billion went to Europe with its vast consumer markets. China attracted a tenth of this amount, because China, even with its vast population, does not have a large and wealthy consumer market. The table below shows the correlation between the size and *wealth* of a market (as measured by per capita GDP) and foreign U.S. investment in manufacturing.

	Per Capita GDP 1999	U.S. Manufacturing Investment 2002 (Millions)
Singapore	$26,300	$16,944
Japan	$23,100	$12,213
France	$22,600	$20,645
Canada	$22,400	$67,209
Germany	$22,100	$27,825
UK	$21,200	$47,285
Australia	$21,200	$10,781
Mexico	$8,300	$19,172
South Africa	$6,800	$1,183

	Per Capita GDP 1999	U.S. Manufacturing Investment 2002 (Millions)
China	$3,600	$6,161
India	$1,720	$2,963

Source: Bureau of Economic Analysis and World Bank

Successful manufacturers do not seek government help to limit competition. They embrace the supply and distribution chains, recognize that their retail customers are closest to the consumer market, and work in partnership to respond to changing market demands.

Trade with China

China is an important source of supply for such consumer products as electronics, small appliances, toys, apparel, footwear and furniture. Imports from China have been growing steadily in the five years since 1999 with the opening of markets, trade liberalization and duty reductions following the Uruguay Round and China's accession to the WTO in 2001. This growth is not unexpected, and should not be characterized as an "import surge." It should be considered as part of the orderly development of trade among trading partners. Indeed, China's share of manufactured imports increased from 9.53% of all U.S. imports in 1999 to 13.37% in 2002—indicating that China is growing, but hardly dominating U.S. imports for manufactured products.

Retailers and their suppliers source in China for many reasons, including quality and diversity of products. Price, as driven by labor and currency issues, is just one factor. Transportation costs from China have declined as major ocean carriers increase their service to areas of the mainland and as port infrastructure grows and makes China a more attractive alternative.

In addition, the events of September 11, 2001 have forced many retailers and their suppliers to evaluate their supply chains and consolidate suppliers to those who are able to meet their demand for a safe and secure supply chain for a reliable and high-quality product at a reasonable price. China has a significant security advantage over other possible sources of supply in Southeast and Central Asia. Finally, the last several years has seen a significant increase in the quality and reliability of Chinese products, causing consumers and retailers to choose them.

Indeed, many of China's leading exports are in product categories where the products have enjoyed reduced duties or become duty-free, where there is little or no U.S. production, or where the United States maintains significant import restraints.

The following chart shows China's the top ten 2002 export categories by value. A few comments are worth making about some of key consumer product exports from China:

Top Ten Categories of Imports from China

HTS Chapter	Description	2002 Imports (value)
85	Electrical machinery and equipment; sound recorders and reproducers, television recorders and reproducers, parts and accessories	$24,256,900,810
84	Boilers, machinery and mechanical appliances; parts thereof	$20,202,307,445
95	Toys, games and sports equipment; parts and accessories thereof	$14,436,614,342
64	Footwear, gaiters and the like; parts of such articles	$10,241,858,412

HTS Chapter	Description	2002 Imports (value)
94	Furniture; bedding, cushions etc.; lamps and lighting fittings; illuminated signs, nameplates and the like; prefabricated buildings	$9,920,730,695
62	Articles of apparel and clothing accessories, not knitted or crocheted	$4,463,625,320
42	Articles of leather; saddlery and harness; travel goods, handbags and similar containers; articles of gut (other than silkworm gut)	$4,436,699,609
39	Plastics and articles thereof	$3,761,319,108
90	Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof	$2,754,415,278
61	Articles of apparel and clothing accessories, knitted or crocheted	$2,606,277,288

Source: U.S. International Trade Commission database

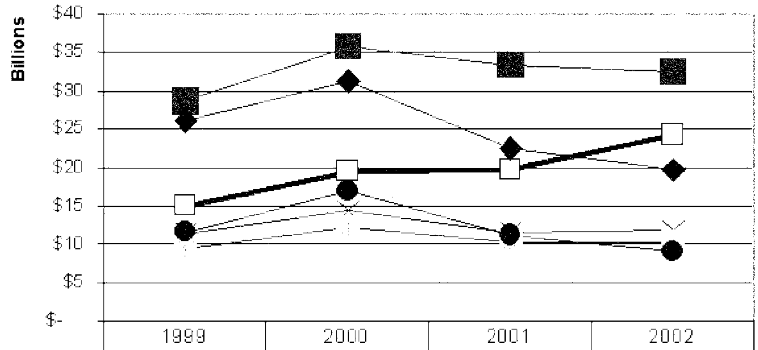
Toys: Most toys are imported into the United States at zero duties because the handful of high-end toy makers in the United States could not possibly meet consumer demand for these products, especially during the holidays at price points acceptable to the ultimate consumer. China's toy exports increased by 18% from 1999 to 2002 at a time when imports from other sources of supply decreased by 12%. Clearly imports of toys from China are not displacing workers in the United States, but China's growth is coming at the expense of other exporters.

Footwear: Like toys, there are only a few shoe producers in the United States, making mostly high-end products. Virtually all athletic shoes are imported. Chinese trade in footwear grew 5% from 1999 to 2002 at a time when imports from the rest of the world declined by a little over 6%. China is not harming U.S. producers or displacing U.S. footwear workers.

Handbags and Leather Goods: China's imports of leather goods grew 12% between 1999 and 2002 at a time when exports from the rest of the world declined by almost 19%. Once again, China appears to have taken market share away from other foreign sources of supply, not from U.S. manufacturers.

Consumer Electronics: Imports of consumer electronics and electrical machinery from China include both finished products and inputs to production that support manufacturing jobs in the United States in the computer and high-tech fields. Many of these products have enjoyed duty reductions or become duty free, thus increasing overall imports. In addition, as in the case for imports of toys, handbags and footwear, China's growth in consumer electronics has come at the expense of other Asian suppliers, most notably Japan, as the chart below shows.

U.S. Imports (by value) of HTS Chapter 85 Consumer Electronics Top Six Exporters



	1999	2000	2001	2002
Mexico	$28,720,078,189	$35,639,862,577	$33,347,846,151	$32,605,755,349
China	$14,915,403,825	$19,359,689,905	$19,610,822,662	$24,256,900,810
Japan	$26,003,333,293	$31,206,635,300	$22,530,130,709	$19,605,916,649
Korea	$11,344,723,116	$14,383,196,904	$11,514,411,921	$11,768,618,606
Malaysia	$9,454,844,085	$12,295,203,449	$10,246,822,302	$10,320,284,052
Canada	$11,580,205,074	$16,902,296,596	$11,061,602,012	$9,045,750,255

Apparel: Imports of finished wearing apparel from all sources continues to grow. Overall trade growth is significantly the result of the domestic industry employing outward processing arrangements that have moved significant production to countries with significant trade preferences (such as Sub-Saharan Africa and the Caribbean). China's trade in woven apparel (HTS Chapter 62) increased 8% from 1999 to 2002 while imports from the rest of the world declined by 4%, indicating that some of China's growth in this category has come at the expense of other suppliers. Imports of knitted apparel (Chapter 61) increased 15% while imports from the rest of the world increased only 3%.

Nevertheless, U.S. apparel makers as represented by their trade association have not complained about this import growth. Indeed, many U.S. producers are themselves actively outsourcing production to remain responsive to the consumer market. More important, domestic producers of these products are already protected by an extensive system of import quotas which have been in place since the 1960s. These quotas will be lifted in their entirety on January 1, 2005 under the terms of the Agreement on Textiles and Clothing for all WTO member countries. China will be subject to a special textile safeguard negotiated under its WTO accession that ensures that trade in this category will be managed by the U.S. government for several more years.

It is important to note that imports from around the globe, including imports from China, serve to keep consumer prices low. Working American families trying to stretch their incomes get a huge benefit from low prices on everyday products like clothing, shoes and toys. Indeed, apparel prices have traditionally increased at a slower rate than general inflation based on years of Consumer Price Index data. No doubt, competition in the market is one important factor in keeping consumer prices low.

The Chinese Currency

Much has been made recently about the "unfair" value of the Chinese yuan with some U.S. manufacturers demanding that government take action to "level the playing field." Some proposals to do this would include imposing punitive tariffs on imports from China, a proposal that would blatantly violate the World Trade Organization and serve to punish consumers and industries that consume production inputs from China. Moreover, such action would likely to result in direct retaliation closing opportunities for U.S. exporters. IMRA strongly opposes such heavy-handed politically motivated "solutions" as contrary to our legal commitments in the international community.

Most economists acknowledge that even if the Chinese relaxed or removed the current peg and the value of the yuan increased, it is not clear how this would impact U.S. manufacturing, *if at all*. IMRA believes a revalued yuan might increase export opportunities for the United States and other developed countries. It should also be noted that U.S. exports to China grew at a faster rate between 1999 and 2002 than Chinese imports to the United States. It does not appear that the U.S. exporters are clamoring for a revalued yuan; it is the domestic producers that are seeking it on the grounds that imports are harming U.S. manufacturing.

While increasing the value of the yuan could increase jobs in export sectors (not necessarily manufacturing, since the U.S. is largely an agricultural exporter), there is no evidence to suggest or reason to believe that increasing the value of the yuan would have a dramatic impact on other kinds of manufacturing jobs in the United States. While imports from China would surely become more expensive, it is reasonable to believe that sourcing for products such as toys, consumer electronics, footwear and wearing apparel would not revert to U.S. suppliers but would instead go to alternate foreign suppliers.

At the same time, increased import prices will have a general inflationary impact not only on finished goods, but on inputs to production that support many jobs in the United States. Increasing the value of the yuan could also have serious adverse implications for other Asian economies. Chinese inputs used in these third countries will become more expensive in turn, making third-country products more expensive. This would in effect take money out of the wallets of Americans and would put a serious drag on one of the few bright spots in the U.S. economy—consumer spending.

IMRA strongly believes that attempts to "level the playing field" via tariffs or other protectionist measures will be counter-productive. To the extent that the United States believes China's currency is a problem, it should pursue changes in international arenas, such as the WTO, and through bilateral discussions and *not* by punishing importers, consumers and industries that rely on parts and components made in China. Congress should not put itself in the position of trying to centrally plan our economy by picking specific industries to "protect" at the expense of other industries, workers and the American consumers who have been carrying the U.S. economy.

IMRA fully believes that China should live up to its commitments made as part of its accession to the World Trade Organization (WTO). If China is failing to implement certain commitments, such as market access, the U.S. should then pursue cases within the WTO. IMRA would like to see China move beyond its commitments on market access for retail stores. Opening the Chinese market further and allowing U.S. retailers to own and operate more than the currently permitted 30 stores, would not only help U.S. retailers, but also those U.S. product suppliers who sell their products in China through U.S. retailers.

It is worth noting that domestic industries have a panoply of U.S. trade remedies at their disposal, including general safeguards, a special safeguard for textiles and apparel, a special China product specific safeguard and regular dumping and countervailing duty laws. These remedies not only increase the price of imports (always at the expense of consumers, consuming industries, and the distribution sector, but also allow U.S. producers to share in the additional tariffs collected. These processes allow a full airing and analysis of the economic benefits and pitfalls that underlie such actions through essentially adversarial actions. If a domestic industry believes it has been injured by trade from China, it has many avenues of recourse at its disposal. None of which are as heavy handed as a blanket import tariff designed to "correct" currency values.

Conclusion

The U.S. retail industry, along with the suppliers and customers that it serves is an essential part of the U.S. economy. Like manufacturers, retailers employ as many workers in good jobs with decent benefits and working conditions. We offer opportunities for entry-level employment, management training and part-time opportunities. Retailing is one of the most important employers of non-skilled workers in the United States, and retailers serve the American market for consumer goods, which ultimately drives the U.S. economy. Retailers also serve the global market for consumer goods and bring U.S. products to the foreign markets, such as China, where they operate.

Foreign competition allows the market to allocate resources to productive industries. Where U.S. manufacturers can no longer produce affordable products, the retail consumer can choose the best source to meet the consumer demand based on many factors. Absent this choice, the retailer and consumer would curtail demand. Imports from China are an important component of the mix of products available. These imports increase customer choice, market variety, and increase demand by making products available to a wider range of consumers at a lower cost. As a result, the nation's consumers benefit. Attempts to set prices artificially through import restraints or tariffs would rob American consumers of disposable income, curtail retail and distribution sector employment and backfire as an attempt to speed economic recovery in the manufacturing sector.

Statement of Ralph J. Pontillo, Manufacturers' Association of Northwest Pennsylvania, Erie, Pennsylvania

I am pleased to submit testimony on behalf of the Manufacturers' Association of Northwest Pennsylvania's (MANP's) Board of Governors and its members regarding the United States-China economic relations and China's role in the global economy. In my testimony, I would like to discuss China's currency manipulation, intellectual property theft, unfair tariffs and taxes, and trade imbalance.

I would also like to acknowledge Rep. Phil English (R–Pa.) for leading the charge in Erie, Pennsylvania, as well as in Washington, D.C., among his colleagues in Congress against the unfair trade practices of China. He also played a vocal role in our recent Labor Day rally drawing more than 500 people and national and international media attention protesting China and other foreign countries' unfair trade practices.

The MANP is the largest regional employers' association of its kind in the country, comprised of more than 6,000 member companies in 17 counties of northwest Pennsylvania. I can tell you that no other issue comes close to commanding the attention that China is receiving from our membership base.

We believe that unless China and other foreign countries engaged in unfair trade practices are required—and we mean required in the strongest terms possible—to play by the established world trade rules, our ability to survive as American manufacturers is lost.

It is critical that our government immediately respond to these disturbing facts and impose sanctions on China that will force the Chinese to comply with the economic engagement rule of law. We remain confident that given a fair and level playing field, American manufacturers can effectively compete worldwide. We are equally confident that unless China is required to play by the rules, the United States and its manufacturing base will suffer long-term consequences. The implications of these consequences will have far-reaching effects on our nation's future.

The MANP firmly believes that American economic and military strengths are directly linked to manufacturing. And make no mistake: We continue to believe that China's markets represent incredible market opportunities for American manufacturers. However, compelling arguments of unfair trade practices demand a forceful response that foreign governments' illegal market manipulation will result in economic sanctions by the United States. Anything less threatens American manufacturers.

Importance of U.S. Manufacturing

It is vital to understand the importance of manufacturing. U.S. manufacturing is the heart of a significant process that generates economic growth and has produced the highest living standards in history. Manufacturing's innovation process is the key to past, present and future prosperity and higher living standards. The intricate process starts with an idea for a new product or process, prompting investments in research and development (R&D). R&D successes lead to investments in capital equipment and workers, as well as "spillovers" that benefit manufacturing and other economic sectors. This process not only generates new products and processes, but also leads to well-paying jobs, increased productivity and competitive pricing. Yet while this process produces wealth and higher living standards, most of it is hidden from view and poorly understood.

According to an article titled "Securing America's Future: The Case for a Strong Manufacturing Base" by Joel Popkin and Company, manufacturing's innovation process provides enormous benefits for the entire U.S. economy:

- First, manufacturing grows the economy. Manufacturing growth spawns more additional economic activity and jobs than any other economic sector. Every $1 of final demand for manufactured goods generates an additional $0.67 in other manufactured products and $0.76 in products and services from nonmanufacturing sectors.

- Secondly, manufacturing invents the future. Manufacturers are responsible for almost two-thirds of all private sector R&D—$127 billion in 2002. Spillovers from this R&D benefit other manufacturing and nonmanufacturing firms. R&D spillovers are enhanced by geographic proximity.
- Manufacturing productivity gains are historically higher than those of any other economic sector—throughout the past two decades, manufacturing averaged twice the annual productivity gains of the rest of the private sector. These gains enable Americans to do more with less, increase our ability to compete and facilitate higher wages for all employees.
- Manufacturing provides more rewarding employment. Manufacturing salaries and benefits average $54,000, higher than the average for the total private sector. Two factors in particular attract workers to manufacturing: higher pay and benefit, and opportunities for advanced education and training.
- Lastly, manufacturing has been an important contributor to regional economic growth and tax receipts at all levels of government. During the 1900s, manufacturing corporations paid 30 percent to 34 percent of all corporate taxes collected by state and local governments, Social Security and payroll taxes, excise taxes, import and tariff duties, environmental taxes and license taxes.

Meanwhile, other nations, recognizing that a strong manufacturing base is the proven path to a world-class economy, have been learning from the American example and are forging their own innovation processes to compete with ours.

America's manufacturing innovation process requires a critical mass to generate wealth and higher standards of living. If the U.S. manufacturing base continues to diminish at its present rate, that process may deteriorate beyond repair and with it, the seedbed of our industrial strength and competitive edge.

Since 1998, America has lost more than 2.8 million manufacturing jobs, and thousands of U.S. manufacturers have downsized, closed plants or moved offshore. This past June was the 35th straight month of jobs lost in the manufacturing sector.

In northwest Pennsylvania, plant closings, downsizing and companies moving offshore have contributed to losing thousands of local manufacturing jobs. What is contributing to this decline? Unfair foreign trade. China, as well as other countries, is unmistakably violating free trade agreements.

China is a member of the World Trade Organization (WTO) and, therefore, has promised to comply with global trade rules. China has violated many sections of the Trade Act of 1974. Some more general, loosely defined "unreasonable" infringements are actions that deny fair and equitable opportunities to establish an enterprise, injure intellectual property rights and deny market opportunities. This is not about protectionism; it's about giving American manufacturers a fair shot, an even playing field.

China: The New Great Wall

To the north of Beijing, a huge wall extends more than 3,700 miles to the east and west. This is the Great Wall of China. The wall is a testament to China's history and is perhaps a testament to its future. The MANP believes the wall both literally and figuratively illustrates the old adage that the more things change, the more they stay the same.

China by all accounts is a closed society. Despite scores of scholarly explanations of Chinese society, little is known about the complex inner workings of this vast communist country. Further, what information is available is closely controlled by the country's central government. The Great Wall is much more than a man-made wonder of the world: It is a telling example of a society that carefully restricts what comes in and what goes out, precisely the purpose of a wall.

It appears that China is building a new wall today, and its implications are no less staggering than the one built throughout a period of more than 2,000 years. The wall the Chinese are building today is an economic wall that accomplishes the same objective as the first—a barricade to control what comes in the country and what goes out of the country.

Unfortunately, China is not, by all accounts, playing by the rules. This fact has disturbing implications, not only to our domestic economy and to our defense, but also to the world's economy and defense. China's new Great Wall consists of an ongoing attempt to capture key industrial markets (keeping something in) and simultaneously restricting access to its markets (keeping something out).

The People's Republic of China is a one-party rule by the Chinese Communist Party. The Chinese Government plays a pervasive role in virtually every aspect of business activity. Extensive government intervention was a key component of China's centrally planned economic system. The state allocated resources, set production targets for all productive units, provided all financing, owned all assets, appointed all managers to its enterprises and generally commanded all economic activities. Since 1997, significant economic reform has occurred within its borders, but as dramatic and energizing as recent reforms have been for the Chinese economy, the government still controls all important aspects of its commerce, including ownership of key plants, land, employment and wages. It also controls and operates the banking system, telecommunications and long-distance transport.

Currency Manipulation

It is estimated that the Chinese yuan is undervalued by as much as 40 percent. Simply stated, when a country artificially maintains a lower value on its currency, the more competitive its products become in world markets. This means Chinese goods can be up to 40 percent less expensive than they should be relative to U.S. goods. China's unfair currency manipulation is costing U.S. manufacturers billions of dollars in lost orders.

Controlling the banking system and the value of its currency is central to China's economic strategy. The Chinese yuan—the most undervalued currency in the world—is pegged to the dollar and protected by capital controls. Using sophisticated methods, UBS, a Swiss bank, calculates the yuan is more than 20 percent undervalued against the dollar. The prime accusation against China is that the country unfairly maintains an undervalued currency in order to make its exports competitive.

In 2001, China's exports rose by 23 percent to $266 billion and accounted for 4.4 percent of all world exports. When you consider that America's biggest bilateral trade deficit is with China ($103 billion in 2002), it is not difficult to see why many American manufacturers are seriously concerned that China may not be playing by the rules. The result of this huge trade imbalance is a dramatic loss of American manufacturers' ability to effectively compete with China. The lower the yuan, the more attractive Chinese-manufactured goods become in the world market. This, in turn, depresses demand for American and other countries' manufactured goods. The result is loss of jobs, lower margins and, in some cases, closings of American manufacturing operations. Put simply, Washington needs to move decisively and quickly to force China into fair and equitable economic policies, including a policy requiring China to cease manipulating currency.

The MANP has joined the Coalition for a Sound Dollar. The purpose of this union is to file a complaint against China, Japan, South Korea and Taiwan under Section 301 of the Trade Act of 1974. This complaint will allege that those countries' governments have engaged in currency manipulation to secure an unfair trade advantage. Those violations break the WTO and the International Monetary Fund rules.

Intellectual Property Theft

In addition to the currency manipulation, China is responsible for the largest portion of world counterfeiting, which costs the United States billions of dollars in lost exports and other related jobs. Plus, counterfeit products pose risks to health and safety. The act of theft can be found in the international trade activities of a number of countries—most notably China. This is a serious accusation and one that cannot be made without a careful and thoughtful analysis. Theft is also one of the most despicable characteristics attributed to a person, institution or country.

In the case of China, the evidence is overwhelming that intellectual property theft runs rampant throughout its commerce and is endorsed and sanctioned by the Chinese Government. The result of this theft has staggering implications to our nation's prosperity and security.

Those who conclude that the piracy of music, CDs, DVDs and other digitized information as minuscule and harmless may want to reconsider their position. Even if you set aside the U.S. copyright industry's loss of $22 billion or the 118,000 jobs lost and $5.7 billion eliminated in wages in the year 2000, this issue goes to the character of the nation.

For example, in the United States, the theft of someone else's property is met with severe penalties, and those engaged in such acts are prosecuted to the full extent of the law. Without this basic protection, our ability to produce and innovate is at risk. Protecting intellectual property is more than a fundamental belief—it is at the heart of any nation's ability to produce products and services to both domestic and foreign markets that ensures fair pricing, safety and a reasonable return on investment.

According to the FBI's Financial Institution Fraud Unit, "Counterfeit products, such as airplane parts, pharmaceuticals, baby formulas and children's toys, are often manufactured using inferior materials and rarely undergo any type of quality control. For example, the U.S. automobile industry, which has estimated sales of counterfeit and imitation replacement parts to be in excess of $1 billion a year, has reported a number of incidences of brake failures caused by brake pads manufactured from wood chips."

In a June 27, 2003, Reuters report in *Automotive News Europe*, automakers now fear copycat cars are next. "General Motors says it's investigating media allegations (Chinese) domestic car producer Chery's just-launched 'QQ' minicar bears a striking resemblance to GM's Chevrolet Spark, due to enter the market later this year." Chery has had its share of controversy as well. Last year, Volkswagen said parts produced by the German company had been used illegally in one of Chery's cars. Yet another complaint revolves around Geely Group and top Japanese automaker Toyota, which is demanding 14 million yuan ($1.7 million) from Geely for using a logo similar to Toyota's in its "Meiri" sedan line, a charge Geely denies. "Foreign automakers have said to me they view the counterfeiters as their largest and most threatening competitor," said Bill Thompson of Pinkerton Consulting and Investigations.

The FBI places intellectual property theft, in general terms, into three categories: copyright, trademark infringement violations and theft of trade secrets. We have already covered the first two. The third, theft of trade secrets violations, "involve the theft of valuable proprietary and sensitive information and includes all types of industries, from manufacturing to financial services to high technology," according to the FBI.

For those who continue to ignore China's serious violations of intellectual property rights despite the billions in lost revenue, hundreds of thousands of manufacturing jobs and billions in lost wages and tax revenue, this third violation should send shivers down your spine.

We are now talking about the theft of valuable proprietary and sensitive information from industries like manufacturing, financial services and high technology, which can have both commercial and military applications.

According to an article written by John J. Tracik Jr. and obtained through The Heritage Foundation's Web site, "One of China's biggest conglomerates, China North Industries Corporation (NORINCO), which is China's premier arms manufacturer, was finally hit with a two-year ban on selling exports to the U.S."

But this only happened *after* NORINCO had sold rocket fuel and missile components to the Shahid Hemmat Industrial Group, the Iranian government agency in charge of developing and producing ballistic missiles. NORINCO is the same Chinese company that smuggled 2,000 fully automatic AK–47 assault guns to drug dealers in California. Special note: Americans each year buy at least $100 million worth of NORINCO products, according to the Commerce Department.

American manufacturers can compete with any nation on Earth. We are second-to-none in production and innovation. But we cannot compete with competitors who can cheat, lie and steal free from consequence.

Trade Imbalance, Unfair Tariffs and Taxes

Challenges for exporters to China include high import tariffs, inappropriate standards, investment barriers, inability to appeal rulings and unequial treatment of foreign and domestic firms. In addition to tariffs, imports may also be subject to value-added and other taxes.

The U.S. trade deficit with China has exploded since China joined the WTO in December 2001. In 2001, America's trade deficit with China was $83.1 billion. In 2002, it increased 24 percent to $103.06 billion. And in 2003, estimates exceed $133 billion.

According to the National Association of Manufacturers, the U.S. trade deficit with China could exceed $330 billion within just five years.

This begs a compelling question: What exactly is causing this massive trade imbalance? That question begets another compelling question: If left alone, what are the implications to the United States?

First on the list is the failure of the United States to maintain a competitive manufacturing infrastructure. Our domestic policies in taxation, regulation, health care, education, and antiquated labor and liability laws have contributed dramatically to our decline in manufacturing competitiveness. In effect, we are killing our golden goose of worldwide manufacturing dominance through our own failure to adequately address our internal domestic weaknesses.

Right behind this is our inability to enforce fair rules of economic engagement. Despite adequate international trade laws and trade rules contained within negotiated trade agreements—and enforceable through the WTO—we continue to cast a blind eye on flagrant abuses of foreign trade partners like China, Japan and Taiwan, among others. In essence, this is giving our trade partners a distinct competitive and unfair advantage over our domestic manufacturers.

Third, we have lost sight of our obligations as Americans and American manufacturers to ensure that our actions are consistent with our national interest. As consumers, we pursue the cheapest products without first questioning how they became so inexpensive. What this means is very simple: Each time we buy a foreign-made product, do we question the methods by which it is produced? In the case of China, we know that products are produced through means of unfair trade practices, which include currency manipulation, intellectual property theft and substantially subsidizing noncompetitive Chinese manufacturers utilizing direct foreign investments—not to mention countless human rights violations and lack of safety standards and regulations. In the final analysis, China's trade imbalance is massive ($133 billion), because Americans buy $133 billion of Chinese-manufactured goods. Put simply, Americans are financing China's ability to utilize unfair trade practices against U.S. manufacturers.

Finally, some multinational corporations have lost sight of their obligations as American manufacturers to refrain from partnering with nations that violate international trade laws.

In a recent article, Terry Jeffrey, editor of *Human Events* and former *Washington Times* editorial writer, quotes Motorola's Web site. "Motorola is moving forward the idea of taking China as its home and development base." According to Jeffrey, "The Web site goes on to say, 'Motorola laid equal emphasis on investment and technology transfer. Local sourcing is an important development rule of Motorola and China. Motorola hopes to take part in China's economic construction by enforcing this rule and strengthening its cooperation with Chinese enterprises. Since the very beginning, Motorola has brought forward the idea of trying to be a good citizen of China, taking China as its home and thriving with the Chinese people. The development strategy of Motorola and China is to build an unbreakable strategic partnership with China. The development goal is to become a true Chinese company.'

"Motorola says that on its Web site," Jeffrey wrote. "It doesn't say it's a U.S. company or an American company. It says that it's a Chinese company, and it's trying to convince the Chinese Government of all these shared interests and all these benefits that Motorola is bringing to China including transferring technology and so forth."

We visited Motorola's Web site and found the following statement about Motorola: "Motorola Inc. (NYSE:MOT) is a global leader in wireless, automotive and broadband communications. Sales in 2002 were $27.3 billion. **Motorola is a global corporate citizen** dedicated to ethical business practices and pioneering important innovations that make things smarter and life better, honored traditions that began when the company was founded 75 years ago this year. For more information, please visit www.motorola.com." We will let Motorola's statement speak for itself.

As we focus our attention on the unfair trade practices with countries like China, we should first recognize our own shortcomings. Like the schoolyard bully who never goes unchallenged, our silence and complacency simply fuel China's fire. China, along with other nations, must be immediately stopped before—like the bully—it goes too far. We also have an obligation as a nation to put our nation's interests before our profits, because it's precisely those freedoms we enjoy as Americans that allow us to earn those profits without resorting to lying, cheating or stealing; it's what separates America from most other nations.

Call to Action

I want to conclude with a final immediate call to action to the U.S. Congress and foremost to the Bush administration.

We urge you and the Bush administration to take direct and immediate action to force China to end currency manipulation. China must permit its currency to freely float based on market conditions

We urge you and the Bush administration to impose immediate trade sanctions against China until China imposes and enforces international trade law pertaining to protecting copyrighted, trademarked and intellectual property.

We urge you and the Bush administration to force China to eliminate all trade barriers imposed by China's excessive tariffs, taxes and import restrictions. Failure by China to comply with the economic rule of law should result in immediate U.S. trade sanctions against China.

We urge the Bush administration to immediately impose import restrictions on all Chinese products imported to the United States at below the cost of the materials to produce them.

Overall, the Bush administration must demand that China play by the same international, economic rules of engagement and rule of law imposed on all members of the World Trade Organization. By doing so, we believe the massive trade imbalance will begin to correct itself based on market forces.

Conclusion

American manufacturing is the backbone of our domestic economy. Our productivity, innovation and exports dramatically contribute to virtually every aspect of American life. Manufacturing is a direct link to our nation's prosperity and security. We believe that given a fair and level economic playing field, American manufacturers can effectively compete and continue to lead the world in innovation and technology.

We believe in open and fair trade agreements. If given the opportunity to compete fairly, American manufacturers will clearly benefit from global market access. We believe the Bush administration and Congress need to move decisively to force China to immediately comply with the world trade rules under the WTO and to stop manipulating its currency by allowing the yuan/dollar-exchange rate to be determined by the market.

Once again, the Manufacturers' Association of Northwest Pennsylvania is calling upon President Bush to impose immediate sanctions against China for willful violations of the WTO. Failure to do so will contribute significantly to the decline of American manufacturing. We cannot stress strongly enough the serious implications of this decline.

Thank you, Mr. Chairman.

Statement of Peter Morici, Alexandria, Virginia

Since economic reforms began in the late 1970s, China has enjoyed dramatic growth and modernization. Important structural changes have included a much greater role for town and village enterprises, private businesses and foreign-invested enterprises, and a diminished, though still significant, role for large state-owned enterprises. Exports, in particular exports to the United States, have played a key role in driving growth.

Like many developing economies, China has employed a variety of trade barriers and industrial policies to steer investment and ensure the rapid modernization of domestic industries, for example in the auto and steel sectors.

As in Japan and other Asian countries, monetary authorities have intervened in foreign exchange markets, consistently buying dollars, U.S. Treasury securities and other reserve currency assets, to maintain an undervalued currency. For example, in the first half of 2003, Asian authorities purchased $79 billion in U.S. federal official assets. This intervention has distorted the growth of trade, stunted Chinese imports and created a large U.S. trade deficit.

Given rapid productivity growth and foreign investments in China, we would expect the dollar value of the Chinese currency to rise with its development progress. However, since 1995 the Chinese Government has maintained a policy of pegging the yuan at 8.3 per dollar.

Since 1995, the U.S. trade deficit with China has grown from $38 billion to $140 billion, and the overall U.S. current account deficit has grown from $105 billion to $555 billion. In contrast, when China was granted most-favored-nation status by the Congress in 1980, the U.S. bilateral trade and global current accounts were in surplus at $2.8 billion and $2.3 billion, respectively.

Consequently, reduced sales and layoffs in U.S. import-competing industries caused by Chinese competition have not been matched by increased sales and new jobs in U.S. export industries at the scale a market driven outcome would require. The free trade benefits of higher income and consumption to the U.S. economy have been frustrated by currency market intervention.

Consequences for U.S. Productivity and Growth

Chronic trade deficits with China, Japan and other countries, which emerged in the 1980s, have reduced U.S. productivity growth and the trend rate of GDP growth by lowering U.S. value added per employee and investments in R&D.

In a nutshell, increased trade with China and other Asian economies should shift U.S. employment from import-competing to export industries. Since the latter create more value added per employee and undertake more R&D, this process would be expected to immediately raise U.S incomes and consumption and boost long-term productivity and GDP growth.

Instead, growing trade deficits with China and other Asian economies have shifted U.S. employment from import-competing and export industries to nontradeable service producing activities. The import-competing and export industries create about 150 percent more value added per employee, and spend more than three times as much R&D per dollar of value added, than the private business sector as a whole.

By reducing investments in R&D, an econometric model constructed for the Economic Strategy Institute indicates the overvalued dollar and resulting trade deficits are reducing U.S. economic growth by at least one percentage point a year—or about 20 percent of potential GDP growth.[1] China accounts for almost half of this lost growth.

Importantly, this one percentage point of growth has not been lost for just one year. The trade deficit has been taxing growth for most of the last two decades, and the cumulative consequences are enormous. Had foreign currency-market intervention and large trade deficits not robbed this growth, U.S. GDP would likely be at least 10 percent greater, and perhaps 20 percent greater, than it is today. GDP and tax revenues would be higher, and the Congress would not be facing large federal deficits. We would not be enduring a crisis in manufacturing and a jobless recovery, and the Congress would not be facing the difficult task of trimming Medicare benefits.

Floating the Yuan

Regarding China, several arguments have been made against letting the yuan float but the underpinnings of these arguments are questionable.

First, it is true that permitting the yuan float would impose difficult adjustments on Chinese state-owned enterprises, disrupt Chinese labor markets and further stress the balance sheets of Chinese banks. However, adjustments of these kinds will only be larger if the yuan is revalued two or five years from now. To avoid such adjustments and sustain its current development model, China will have to purchase ever-larger amounts of dollars, and transfer ever-larger amounts of what it makes to U.S. consumers. How long can that be sustained?

Second, some have argued a revaluation of the yuan would cause a productivity burst in China, wiping out the competitive gains for U.S. import-competing and exporting business. Some burst is likely but it would not be large enough to wipe out completely the competitive effects of yuan revaluation. Moreover, to the extent that a 30 or 40 percent jump in the dollar value of the yuan did not wipe out China's trade surplus and the excess demand for yuan in currency markets persisted, the dollar value of the yuan would just rise further. Productivity gains in China would cushion inflationary effects all around.

Third, the U.S. is dependent on Chinese and Japanese official purchases of Treasury securities (currency market intervention) to finance its federal budget deficit. However, absent this intervention, the exchange rate for the dollar and trade deficits would be lower, and GDP and tax revenue would be higher. To the extent additional tax revenue did not close the federal financing gap, the Fed could purchase additional Treasury securities to maintain interest rates—something it routinely does to expand and regulate the money supply. Instead of the Chinese and Japanese monetary authorities purchasing Treasury securities, the Fed could make those purchases.

Statement of William Wolf, Motion Systems Corporation, Eatontown, New Jersey

This statement is submitted on behalf of the approximately 70 employees of Motion Systems Corporation of Eatontown, New Jersey and their families. Motion Systems has been in business since 1972. We produce electromechanical linear actuators, pedestal actuators, and ball drives, among other products. Our customer base includes U.S. military contractors that use our products to build weapons and equipment for our country's national defense. Therefore, the products that we manufacture must be produced to the highest quality standards, and our reputation for excellence is well-known throughout the industry.

The Committee has requested written submissions to address, among other issues, the relationship between trade with China and the U.S. economy, particularly the manufacturing sector. With respect to this particular issue, Motion Systems has first-hand experience as to the impact of Chinese imports on the U.S. manufacturing sector. We also have first-hand experience with seeking assistance from

[1] Peter Morici, *The Trade Deficit: Where Does It Come From and What Does It Do?* (Washington, DC: Economic Strategy Institute, 1998). The model indicates that each addition of $140 billion to the trade deficit reduces U.S. growth by 0.5 to 0.6 percentage points.

our government to remedy the harm caused by Chinese imports. It is this experience which is the subject of these comments.

As noted above, among the products that we manufacture is an item known as a pedestal actuator. Pedestal actuators are designed for use in applications where up-and-down movement along a single axis is required to adjust the height of a surface while maintaining a stable base. Applications include dental equipment, hospital incubators, but the majority of pedestal actuators are used in mobility scooters to automatically lift and lower the seat. Beginning in 1979, Motion Systems has produced tens of thousands of pedestal actuators.

In 2002, Motion Systems lost our largest pedestal actuator customer account to a Chinese company that copied our product and then sold it to our former customer for less than one-third the price for which Motion Systems had sold the same product. As a result, Motion Systems' pedestal actuator business was decimated. We decided to go to Washington, D.C. in the early summer of 2002 to ask our government for help. We met with officials at the U.S. Trade Representative's office, who advised us to trademark our product in China (even though we have never sold any products in China!).

We then learned about a trade remedy law called Section 421 of the Trade Act of 1974. Also known as a "China specific safeguard", this statute was expressly written into U.S. law as a condition for giving China permanent normal trade relations and WTO membership. The law went into effect in December 2001, when China's accession to the WTO was completed. Under this law, if the U.S. International Trade Commission determines that increased imports from China are causing market disruption to a domestic industry, the President must then grant such relief as to eliminate or prevent the market disruption. There is a narrow exception, which provides that the President may decide not to grant relief if, *and only if*, he determines that taking action against Chinese imports would have an adverse impact on the U.S. economy clearly greater than the benefits of such action. Statements by USTR, Cabinet officials and members of Congress during consideration of the legislation that included Section 421 in 2000 made very clear that Section 421 was intended to be a strong remedy against import surges from China.

Another important advantage that Section 421 offers is a speedy proceeding. Once a petition is filed, the International Trade Commission must decide within 60 days whether there is market disruption caused by Chinese imports. The President must make his decision on relief within 150 days of the petition's filing. This is particularly important to small businesses and industries that do not have the resources to pay for expensive and lengthy antidumping cases. Speed is also necessary to ensure that an industry can get relief before it is completely overtaken by surging Chinese imports.

We filed the first Section 421 petition in August 2002. In October, the International Trade Commission determined that imports of pedestal actuators from China had indeed caused market disruption and recommended that the President impose quotas for three years. Up to this point, we believed that the law was in fact working as intended. During the next several weeks, however, we saw the Government of China impose enormous pressure on the Bush Administration not to grant relief. Press reports revealed that high-level Chinese officials traveled to Washington, D.C. to lobby our government in private against granting relief. We simply did not have the resources to match that kind of lobbying effort, having already spent more than half a million dollars on legal fees. It's worth noting here that while Administration officials were meeting privately with Chinese Government officials about this case, our requests to meet with USTR were turned down. Apart from the public hearing, our contacts with USTR were limited to a handful of telephone calls, most of which dealt with purely procedural issues.

Not surprisingly, the President decided against granting relief, although the reasons he gave for his decision were not supported by the factual record. In particular, the President's decision stated that cost of a quota to the downstream users of the product (i.e., our former customer and its customers) would substantially outweigh any benefit to Motion Systems. This conclusion was presumably premised on the unsupported and unsworn statement from our former customer that they had reduced the prices of their mobility scooters in part because of the lower priced Chinese actuators. No objective evidence was ever provided to support that claim. Indeed, after the President's decision, we came across new information that indicated our former customer had *not* reduced its prices after switching to the Chinese import. We brought this information to USTR's attention, but no action was taken.

I am, of course, extremely disappointed in the President's decision because of what it means to Motion Systems. If the Chinese can copy one model of our actuators, they can surely copy other models and sell them to our remaining customers. (Notably, the President apparently never even considered imposing quotas that would have at the least protected our market from further encroachment from Chinese copies.) However, what happened in our case goes far beyond the pedestal actuator industry. The Committee has received a great deal of testimony from other companies about the adverse impact of Chinese imports on the U.S. economy. That small U.S. businesses are confronted with waves of imported products built by a labor force that is paid 83 cents an hour (according to the U.S. Department of Commerce) in an economy that does not operate according to free market economic principles is bad enough. This injury is compounded by the insult of a government that is far more responsive to lobbying and pressure from a foreign government than to the entreaties of its own citizens to apply the trade remedy laws that Congress has provided to address injury caused by Chinese imports.

On September 16, 2003, Commerce Secretary Don Evans gave a speech at Carnegie Mellon University, during which he said: "The President knows that competition leads to innovation and improves productivity. . . . [T]he Bush Administration will not stand for unfair competition. Americans are willing to compete, *on even terms*, with any country in the world *as long as it is fair*." (Emphasis added.) But what the Administration fails to explain is how we can compete with an economy that pays its workers about 83 cents an hour. Even the most modern production facilities cannot compete if the manufacturing includes a labor component. We are not competing against laborers who are using primitive tools and equipment. To the contrary, Chinese companies are equipping themselves with modern machine tools. In 2002, for example, China bought almost twice what U.S. companies bought in new machine tools.

The United States has encountered this before when Japan began to emerge as a major economic power. It took 30 years for Japanese wage rates to normalize, during which large chunks of the U.S. manufacturing base were lost. Given the size of China's population and the large numbers of unemployed workers, it could very well take a century or more for China's labor rates to normalize. In the meantime, the U.S. manufacturing sector will not be able to fund research and development, and American innovation will end.

The Government of China controls prices for many key inputs, including energy fuels, and props up state-owned enterprises. It deliberately keeps its currency undervalued, which means that the cost of producing products in China is kept artificially low. Yet, when all of these policies and practices lead to surges in imports that threaten to destroy a U.S. industry, the Administration fails to act. So long as our government is more concerned about giving offense to the Chinese Government than about giving relief to injured domestic industries under trade rules expressly agreed to by China, then the prospects for companies such as Motion Systems from increased trade with China are dim indeed.

Statement of Motor and Equipment Manufacturers Association

China has emerged as a market of enormous importance to U.S. manufacturers of automotive parts and components ("automotive products") and motor vehicle manufacturers. China has tremendous pent-up demand and production potential in the automotive sector.

China's light vehicle production (passenger cars and light trucks) is predicted to reach 3.4 million units in 2003, up from 2.6 million units in 2002, and is currently predicted to reach 5 million units by 2005, according to CSM Worldwide. Most of the world's leading automakers, including the Big Three, have made significant investments in China to take advantage of its market and production potential. Growing production in China creates demand for original equipment (i.e. "OE") automotive products at the time of production and in later years demand for automotive products to maintain and repair the vehicles as they age (i.e. "aftermarket parts"). In every market, growing vehicle sales over time leads to a larger national car parc and greater demand for aftermarket automotive products to maintain and repair motor vehicles.

Investment in motor vehicle production capacity by U.S., Japanese, Korean and European automakers have generated investment by U.S. manufacturers of O.E. automotive parts and components suppliers has grown along with. U.S. automakers are strongly encouraging their parts suppliers to source products from China, for use in local production, and for export back to the U.S. or third markets. In many cases, U.S. automotive parts manufacturers have formed an alliance with local Chinese manufacturers, an investment trend which will probably continue in the future.

On the U.S. import side, U.S. manufacturers of automotive aftermarket products have faced significant competition from imports from China for many years. As Big Three and other automakers seek to maintain market share in the U.S. through cost cutting, more U.S. O.E. manufacturers are expected to shift production to China, or compete with imports from China on the O.E. side of the automotive parts and components market. As this trend in sourcing develops, motor vehicles assembled in the U.S. will contain more Chinese content.

United States manufacturers of automotive parts and components have been long-time supporters of free trade. The industry was a driving force behind creation of the U.S.-Canada FTA, and the NAFTA, and supported PNTR for China and China's admission into the World Trade Organization. As an industry, manufacturers of automotive products have been progressive and forward thinking in its attitudes toward trade and globalization. At this time, however, we do have serious concerns about the U.S.-China economic relationship and China's implementation of its WTO obligations.

Counterfeiting and Ineffective Enforcement of IPR Protection

Counterfeiting and intellectual property right violations are estimated to cost U.S. manufacturers of automotive products $12 billion per year. MEMA has identified China as the primary source of counterfeit automotive products in the world. Counterfeiting in China is rampant, and often blatant. MEMA and its members have identified a wide range of products that have been counterfeited and sold in the U.S., in China or in third markets, including automotive glass, brakes, fuel filter, oil filters, wire sets, radiators, batteries, shock absorbers, pumps, sirens (for use on emergency vehicles), spark plugs, structural components, piston rings, gas caps, brake fluid, transmission fluid, coolant and other products.

Counterfeiting and other IPR violations cost U.S. manufacturers in our industry billions in sales globally, but the damage is not limited to lost sales. Counterfeit products marked as a well know American brand are usually of inferior quality, a fact that becomes apparent to the distributor or the final customer after the purchase. This leads to destruction of a company's brand and reputation in the market. It is extremely difficult to calculate the full extent of losses coming from destruction of brand and reputation, as it amounts to attempting to track sales lost, rather than made. A distributor or a customer will simply switch brands, with no explanation. Often when IPR violations have been detected, U.S. manufacturers will spend hundreds of thousands of dollars redesigning the product or packaging, investigating the violations, and taking legal action against the counterfeiter. This represents a tremendous drain on corporate budgets in a highly competitive global market.

China needs effective laws and enforcement to criminalize counterfeiting. It also needs to enforce commitments to stop the export of counterfeit goods.

Misuse of Federal Safety Standard Markings and Industry Certifications

MEMA has also identified China as the major source of automotive products sold in the United States that do not meet Federal Motor Vehicle Safety Standards (FMVSS) or the industry standards set by the Society of Automotive Engineers (SAE). Automotive lighting has been particularly affected by this problem. Automotive lighting subject to FMVSS is stamped with the initials "DOT" and "SAE", indicating compliance with FMVSS and the product standards developed by the Society of Automotive Engineers. Distributors, retailers and other customers in the U.S. market must be able to rely on these markings as a sign of quality and compliance. MEMA and its members regularly find lighting products originating from China in the stream of Commerce that are marked "DOT" or "SAE" but do not meet the regulation or the industry standard. This compromises highway, and is putting legitimate U.S. manufacturers who comply with the standards at a competitive disadvantage to the Chinese producers who do not.

China needs effective laws and enforcement to criminalize willful misrepresentation in product marking.

Currency Manipulation

As noted above, U.S. manufacturers of automotive aftermarket products have faced significant competition from imports from China for many years. Currency manipulation by the Chinese to gain a trade advantage has exacerbated the problem. China has maintained its currency at the same level against the U.S. dollar since 1994—despite a huge increase in production capability, productivity, foreign direct investment inflows and other factors that would normally be expected to cause currency to appreciate in value. The currency is controlled by the government and is not allowed to fluctuate freely. China maintains enormous reserves of U.S.

dollars to control its currency relative to the U.S. dollar. Estimates by the Institute for International Economics point to an under-valuation of the yuan of between 15 to 40 percent.

MEMA is encouraged by the Administration's initiatives to persuade the Chinese to take steps toward allowing the value of the yuan to be determined by market forces. At a minimum, a reevaluation of the 1994 peg to the dollar by the Chinese is urgently needed, with further adjustments to follow in an orderly but deliberate fashion.

Central Planning in China's Automotive Sector

The Chinese automotive industry must function under a series of government five-year plans and policy statements. These plans and policy statements address production, expansion and consolidation, technology transfer, joint venture ownership, export incentive programs, environmental issues, automotive financing and other issues. These plans or policy statements often specifically address the government's desire to develop its domestic base of automotive suppliers.

MEMA is concerned that these plans and policies, which have major, long-term implications for U.S. industry, have never been developed in a clear or transparent manner. Useful information about the actual implementation of the plans and policies is often lacking and not transparent.

The lack of transparency in the development and implementation of plans and policies is a serious problem for U.S. automotive suppliers seeking to invest and develop business in China. The lack of transparency will become an even more serious impediment to progress for U.S. industry, as China's domestic automotive market grows and production in China continues to become more integrated into the global automotive industry.

MEMA believes the Chinese Government must commit to developing clear and transparent administrative procedures, similar to those in place in other major economies. Also, China must commit to implementing its plans and policies affecting the automotive sector within its WTO obligations.

Statement of Wilbur L. Ross, Jr.

As chairman of International Steel Group, Inc., the second-largest integrated steel producer in the United States, and as the soon to be chairman of Burlington Industries, I welcome this opportunity to share with the Committee on Ways and Means my views on economic relations between the United States and the People's Republic of China, and the ever-worsening impact of the rising tide of Chinese imports on U.S. manufacturing industries, including steel and textiles and apparel.

ISG was created in the spring of 2002 at the time that President Bush determined to give the U.S. steel industry temporary relief from import competition that had helped to put more than 30 domestic steel companies into bankruptcy. ISG raised the capital to acquire the production assets of three of those companies—LTV Steel, Acme Steel and Bethlehem. At the time of their acquisitions, the assets of LTV and Acme were completely idle and Bethlehem was facing a possible shutdown. Working together with the United Steel Workers of America, we managed to bring these facilities back on line to reasonable levels of capacity utilization while significantly increasing productivity. Today, ISG is a state-of-the-art, globally competitive steel producer with more than 16 million tons of capacity.

Burlington Industries is one of the world's leading soft goods manufacturers, producing a broad range of textile and apparels products. From its origins in 1923, Burlington has been an innovator specializing in rapid change to spearhead new fashion trends and cutting-edge technologies. While it has recently encountered financial difficulties that forced it into bankruptcy, Burlington is poised for a return to profitability.

ISG and Burlington have the resources, production assets and people necessary to make them fully competitive on a global scale. Otherwise, my company would not have invested several billion dollars to acquire their assets. For these and other U.S. manufacturing companies and industries to succeed, however, they must be allowed to compete on the proverbial level playing field. Unfortunately, the playing field of international trade today is heavily tilted against U.S. companies. This is particularly true when it comes to competition from China, as evidenced by the explosion in our trade deficit with China. In ten years, the U.S. trade deficit with China has grown from $4.8 billion to $147.2 billion.

Competition, of course, is the foundation of our economic system, and countries do benefit when they invest resources in those products where they have a comparative advantage vis-à-vis other countries. However, trade and competition in a free market capitalist economy such as ours presupposes that all players are operating under the same rules and that markets are responding to rational signals. A careful examination of China's economy and economic policies indicates that China is not operating according to the same rules that operate in our and other free market economies. As a result, production costs in China are not "real", but in many cases are distorted, and usually artificially low. As a consequence, investment flows lead to the build up of capacity in many industrial sectors, including steel and textiles, which results in surplus production and import surges in other markets.

The list of economic policies and practices in China that distort the market includes:

- A substantially undervalued Chinese currency: Currency misalignment can result from either under-valuation or over-valuation of a currency. In either case, the effect is significant trade distortion, misallocation of economic resources and instability. In the case of a country such as China, a currency that is undervalued produces false market signals by making industries in that country appear more competitive than they actually are, which encourages overexpansion of production and export flooding. Since 1994, China has maintained a fixed exchange rate for their currency relative to the dollar. The rate has been pegged at about 8.28 yuan/dollar for the entire period. Notwithstanding the substantial expansion of China's economy and increase in exports, the value of China's currency vis-à-vis the dollar has not changed. In order to maintain this fixed rate of exchange, China's central bank has had to intervene in the foreign exchange market by selling yuan in exchange for dollar denominated assets when the demand for the yuan increases and buying yuan with dollar denominated assets when the demand for the yuan decreases. Since the end of 2001, dollar buying has been so great that the foreign reserves held by the Chinese Government have risen by $171 billion to $384 billion (as of end-September).
- Provision of massive domestic subsidies to spur economic development and to cover large operating losses in key industries, including steel: Although China committed to eliminating various non-agricultural subsidies immediately upon its accession to the WTO and phasing out other subsidies, China in fact continues to use subsidies widely, often through assistance to state-owned enterprises that are operating at a loss. Continued subsidization of the Chinese steel industry in particular has fostered massive capacity increases in China that are not driven by rational market signals. The massive capacity expansion in China will exacerbate the problem of global excess capacity and lead to increased exports of Chinese steel products when demand in China diminishes.
- Government price controls on energy, including crude oil, electricity, and natural gas: China's energy sector is largely controlled by state-owned enterprises, including China National Petroleum Corporation (CNPC), China National Petrochemical Corporation (Sinopec), and China National Offshore Oil Corporation) (CNOOC). It has been national industrial policy in China for many years to provide electricity at preferential rates to industries with high levels of energy consumption. One of the provisions of the 2003 Regulation and Control Outlines of Economic Operation formulated by the former State Economic and Trade Commission of China proposes "providing preferential electricity rates to industries with high consumption and high cost of electricity, such as caustic soda, electrolytic aluminum, special steel, carbon products, etc." In order to stimulate foreign investment, local governments often require that power utilities institute preferential utility prices for foreign investors. Efforts to introduce market-based reforms are only just beginning and are likely to take a long time to complete.
- Export subsidies and tax breaks that are contingent on export performance: It is not clear whether China has in fact carried out its commitment because China has not submitted its required annual subsidy notification to the WTO's Committee on Subsidies and Countervailing Measures for the last two years. However, the experience of U.S. industries indicates that export subsidies continue to be provided. China also provides tax relief to foreign investors that is export contingent. Chinese officials have acknowledged that China uses its tax laws to encourage the formation of wholly foreign-owned enterprises that are export-oriented. Specifically, China exempts wholly foreign-owned enterprises that are export-oriented from paying income tax for a certain period of time, which is followed by an additional period during which the enterprise is entitled to a 50 percent rebate of income tax. Enterprises located in special economic

zones, or economic and technology development zones, or any other exporting enterprises that already enjoyed an income tax rate of 15 per cent, would pay income tax at the rate of 10 per cent if they also met certain requirements.

- Labor practices that include denial of internationally-recognized worker rights and failure to enforce national and local labor laws, which distort the cost of labor: The Congressional-Executive Commission on China has reported extensively not only on how China denies its workers the right to organize independent unions, but also on how China's own labor laws governing wages, working hours, working conditions and overtime are routinely ignored.
- Controls on capital investment and foreign investment that direct investment toward government-favored sectors: Foreign investment in China continues to be controlled and channeled toward areas that support national development objectives. Projects in sectors that are favored by the government receive such preferential treatment as duty-free import of capital equipment and rebates of value-added tax on inputs. Foreign-invested enterprises in China also are largely unable to access domestic and international stock markets, to sell corporate bonds or accept venture capital investment, to sell equity or engage in normal merger, acquisition or divestment activity. Further, foreign exchange transactions on the capital account must undergo case-by-case review prior to receiving approval, which are themselves subject to very tight regulatory controls. China has not committed to removing any of these restrictions as a condition of WTO accession.

In addition to the substantial market distortions resulting from these and other policies and practices, China also maintains significant tariff and non-tariff barriers to imports that deprive U.S. exporters the same access to Chinese markets that Chinese producers have to U.S. markets. These barriers include:

- High tariffs: Even after reducing its tariffs in accordance with the terms of its accession to the WTO, Chinese tariffs remain relatively high, particularly when compared to U.S. tariffs. In 2002, China's average tariff rate was 12 percent, compared to 1.7 percent for the United States. For some products, such as passenger cars, the tariffs range from 25 to 40 percent, compared to the U.S. rate of 2.5 percent. High tariffs on downstream products that are important to the steel industry depress demand for steel that could otherwise be used to build cars for the Chinese market.
- Import substitution policies: China continues to encourage import substitution in a number of important product sectors, including the auto sector. Notwithstanding pronouncement that China's preferential policy for automobile localization rates would be cancelled upon WTO accession, U.S. auto manufacturers have reported that local government officials in 2002 had continued to cite the old auto policy's localization standards when they required high local content.
- Lack of transparency in regulations and procedures: China has a very poor record of providing transparency in its promulgation of laws and regulations. According to the Office of the USTR, "measures" that do not rise to the level of ministry-issued regulations remain unavailable to the public. In 2002, for example, China failed to publish all "measures" related to trade, which puts foreign businesses at a distinct disadvantage vis-à-vis their Chinese competitors.
- Taxes that discriminate against imports: China's Value Added Tax (VAT) is not always applied equally to imports and domestically-produced products. For some products, such as semiconductors, China has substantially reduced the VAT and has exempted certain other domestically-produced products altogether. China's consumption tax also discriminates against imports because China uses a substantially different tax base to compute consumption taxes for domestic and imported articles.
- Efforts to bring China into full compliance with WTO commitments are lagging: China's progress toward completing implementation of its WTO commitments is unsatisfactory in numerous other areas, including customs valuation, rules of origin, tariff commitments, import quotas, tariff rate quotas, import licenses, export licenses and fees, sanitary and phytosanitary standards, technical standards and the like. There are entrenched domestic interests in China that actively oppose further reform and opening of China to competition from abroad. I would strongly urge the Ways and Means Committee to call upon the Administration to begin using the WTO dispute settlement mechanism to address this long list of non-compliance with WTO obligations by China.

There is also virtually unanimous agreement that China's enforcement of intellectual property rights remains entirely inadequate. For example, China remains one of the few countries in the world that fails to actively use its criminal laws to prosecute and punish commercial copyright pirates and trademark counterfeiters. Intellectual property protection is of great importance to textile and apparel manufacturers seeking to establish and maintain brand-identity and loyalty. A recent survey by the National Textile Association reported that over half of the companies responding stated that IPR was either somewhat or very important to their business. China's failure to protect textile and apparel-related IPR is well-documented, with reports of "knock-off" consumer products, including textiles and apparel, being widely available almost everywhere in China. Infringing products are also causing harm in this country as China is a major source of imports that infringe textile and apparel IPR.

As the United States works toward eliminating trade distorting practices and barriers to market access, we must also fully implement rights negotiated prior to, and as a condition of, China's WTO accession. These are rights that were specifically demanded because U.S. industries could foresee many of the problems that we were going to encounter with China. Indeed, the support of numerous U.S. industries for China's accession to the WTO was conditioned upon the inclusion of these important concessions by China. Unfortunately, the current Administration has not "stepped up to the plate" when it comes to administering the laws under which these rights are made available to U.S. industry.

Two of these rights in particular concern special China-specific safeguard measures against injurious import surges. The first is a special textile safeguard that permits the United States to require restraints on imports of Chinese textile and apparel products even after the elimination of textile and apparel quotas under the WTO's Agreement on Textiles and Clothing. Although this safeguard took effect as part of U.S. law upon China's accession to the WTO in December 2001, it took nearly seventeen months for the Committee to Implement Textile Agreements, part of the Department of Commerce, to promulgate procedures to allow the filing of petitions seeking relief from injurious imports. According to the American Textile Manufacturers Institute, while CITA's procedures languished in the government bureaucracy, Chinese textile and apparel imports increased more than 165%, while 50 textile plants were forced to close, putting some 39,000 textile workers out of work.

The procedures themselves also involve numerous delays before any decisions are made. Under CITA's provisions, it can take more than three and one-half months to decide whether to use the safeguard provision in response to the filing of a petition. Worse yet, at the end of that period, if CITA determines it cannot make a decision whether to grant or deny a request for action, it is simply required to give notice as to when it will make a decision. In other words, the procedure is entirely open-ended.

Several petitions invoking the special textile safeguard were filed on July 24, 2003. CITA's initial deadline to decide whether to grant or deny the requests for relief is set to expire on November 17. But, as noted, even then CITA is not required to make a decision. The process is completely untenable.

The second China-specific safeguard is Section 421 of the Trade Act of 1974. Under Section 421, the U.S. International Trade Commission must determine whether increased imports from China are causing or threatening to cause market disruption to a domestic industry. If the ITC makes an affirmative determination, it recommends to the President what relief should be provided. The President must then grant such relief as to eliminate or prevent the market disruption. There is an exception to the requirement that relief be granted. The President may decide not to grant relief only if he determines that taking action against Chinese imports would have an adverse impact on the U.S. economy clearly greater than the benefits of such action. However, both the legislative history and statements by USTR, Cabinet officials and members of Congress during consideration of the legislation that included Section 421 in 2000 made very clear that the exception was to be construed narrowly and that Section 421 was intended to be a strong remedy against import surges from China.

Unfortunately, as administered to date, Section 421 is not providing the relief that Congress intended. In the first two cases to reach the President, relief from injurious import surges was denied. In the first case, involving pedestal actuators, a component product used in mobility scooters, the President cited the increase in the cost of the component to the downstream users as one reason not to grant relief. However, such reasoning virtually assures that relief will never be granted under Section 421 because replacing the Chinese product with the domestically-produced product will always result in some increase in the price to the downstream customer. If Chinese products were not so low-priced in the first place, they would not pose a threat to U.S. producers.

In the second case, which involved wire garment hangers, the President denied relief because of a concern that the relief would have an "uneven" impact on the domestic industry because one domestic producer also distributed imported Chinese hangers (although the President acknowledged that most domestic producers would see an increase in their income if relief were granted). There is no requirement in the statute that relief affect all producers evenly. It is also particularly troubling that relief to an entire industry would be denied because it might adversely affect the interests of a single producer.

There is a procedural problem with the law as it is administered by the ITC. The ITC's regulations require petitioners to indicate how they will use the period of relief to adjust to Chinese import competition. Unlike the global safeguards provisions of Section 201, Section 421 does not require the domestic industry to adjust to import competition. Indeed, Section 421 was established because it was recognized that China is in the process of transforming its economy. The burden for making adjustments should be on Chinese producers and exporters.

In addition to these China-specific safeguards, the United States must also improve its enforcement of other trade remedy laws as applied to China. The Commerce Department's enforcement of the non-market economy provisions in the antidumping law is problematic and often produces irrational results. For example, if a Chinese producer purchases an input from a market economy country, then Commerce normally will use the actual price paid for that input as the factor value, even if the quantity supplied by the market economy country accounts for only a small percentage of the total input used. The rule invites gaming by Chinese producers who can shop for and purchase a small volume of inputs from market economy producers at "fire sale" prices.

Commerce also has an overly restrictive policy for disregarding prices paid by Chinese producers for inputs from market economy countries where there is reason to believe or suspect such prices may be "dumped." (In 1988, Congress instructed Commerce not to use such prices if it had reason to believe or suspect they may be dumped or subsidized, but rather to use alternative sources for prices.) Before Commerce will reject prices as possibly "dumped," it requires evidence that China has an antidumping order on the imported product from the same country from which the Chinese producer purchased it. Since China has only recently started to use its antidumping law, Commerce's policy virtually ensures against the rejection of such prices, regardless of whatever other evidence a petitioner might produce.

Commerce also fails to require Chinese producers to provide the same extent of information in antidumping cases that is required from producers in market economy countries. For example, if a Japanese producer has two factories, only one of which produces product exported to the United States, that producer must provide information about both factories. A Chinese producer with two factories, however, is only required to report information on the factory that produces products exported to the United States.

Finally, Commerce's policy of not applying the countervailing duty law to China because it is a non-market economy is hopelessly outdated. There is no dispute that China provides extensive subsidies to various industries, including steel and textiles. While it may be difficult for Commerce to find suitable benchmarks with which to measure Chinese subsidies and the benefits they confer on Chinese producers, that is not justification for what is tantamount to unilateral disarmament with respect to this shield against unfair imports. Moreover, there is nothing in the statute that commands such an outcome. Commerce can change its policy. However, to the extent that it feels constrained by the law as currently written, then it is incumbent upon the Congress to amend the countervailing duty law to make clear that it is applicable to imports from China.

In conclusion, and on behalf of the employees of ISG and Burlington Industries, I thank the Committee on Ways and Means for this opportunity to address the serious problems facing U.S. industries from U.S.-China trade. As reviewed, the challenges are both numerous and substantial. However, there is no question in my mind that the challenges can be met successfully, provided that our government and our trade negotiators and policymakers have the willingness to do so.

Statement of the Securities Industry Association, New York, New York

The Securities Industry Association [1] is pleased to submit this testimony about China's capital markets and the opportunities for U.S. firms, our clients, and the

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the

U.S. economy to do business in China. Our testimony will focus on the goals and objectives of the U.S. securities industry in our growing relationship with China's economy. Consequently, this testimony highlights some key issues related to China's capital markets. SIA is currently in the initial stages of developing a more detailed paper on market access barriers to China's capital markets faced by U.S securities firms.

SIA has long supported more open, fair and transparent markets, and has strongly advocated liberalization in U.S. multilateral and bilateral trade discussions—including China's WTO accession talks. The economic benefits of financial services sector liberalization reverberate throughout the world from widespread increased opportunities created by new entrants, innovative products and services, and capital markets with greater depth and efficiency. In the global economy, open and fair markets are essential to ensuring that markets operate efficiently so that investors can easily and quickly buy and sell shares across borders, while businesses can access capital at the lowest price. The international financial system has been a major and contributing factor in the marked increase in living standards of those countries that participate in it.

China's WTO accession commitments for financial services, and more specifically for the securities industry, demonstrated a reluctance to open this sector fully to foreign competition. We believe China should improve and accelerate its financial sector reform so that it will have the financial tools necessary to sustain and improve the quality of its economic growth.

Expanding Business Opportunities for U.S. Financial Services Firms

Many of SIA's leading member-firms have identified China as the largest single emerging market opportunity, with some measures indicating that China will be the world's largest economy within the next 40 years.[2] Analysts also predict that China will invest more than $1 trillion in transportation and communications infrastructure improvements and energy-related capital equipment over the next decade. In addition, China will accelerate its privatization program, and hopes to encourage foreign investors to participate.[3]

Moreover, China's nascent pension system must deal with a rapidly aging population. In 1995, the percent of China's population over 65 was 6.1 percent; it is projected to reach almost 14 percent by 2025. World Bank estimates indicate that by 2030, the Chinese pension system will total $1.8 trillion. Already, several U.S. and other foreign firms have begun to capitalize on the enormous opportunities in China's retirement market by signing technical assistance agreements with local fund management companies.

China's capital markets have grown significantly over the past decade and helped finance the country's domestic growth. China did not have a functioning stock market until 1991. By 2002, China's equity market capitalization totaled $463.1 billion and was the largest emerging stock market in the world. Impressively, between 1995 and 2002, China's stock market capitalization soared by about 40 percent per annum, increasing the value of Chinese stocks to 19 percent of all emerging markets. China also boasts 1,235 listed companies, exceeded in the emerging markets only by Korea (1,526) and India (5,650).

China's domestic capital markets will benefit from the entry of U.S. securities firms and their technology, capital, innovative products and services, and best practices. As local firms prepare for this increased competition, they will adopt new technologies and improve the quality of products and services they offer. More competitive and efficient capital markets will also improve the allocation of capital to borrowers and users, facilitate the hedging and diversifying of risk, and assist the exchange of goods and services. As China's capital markets develop, Chinese firms will be better able to raise low-cost capital and support job creation. Since financial markets are inextricably linked to increased investment and economic growth, strength-

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shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $222 billion in domestic revenue and $356 billion in global revenues.

[2] Goldman Sachs' Global Economics Weekly, Issue 03/34, 1st October 2003

[3] China Accelerates Privatization, Continue Shift From Doctrine, Philip P. Pan, Washington Post, November 12, 2003.

ening China's domestic capital markets will help to alleviate the significant financing constraints that Chinese firms currently face.[4]

China's private and public sectors alone cannot mobilize the massive financial resources, advice and expertise that are necessary to sustain its economic growth. Much of the infrastructure development will, by necessity, be funded through foreign sources, and this opportunity has generated substantial interest by the U.S. securities industry. Indeed, despite difficulties entering and operating in China, numerous U.S. securities firms have established offices in China and have participated in China's international securities offerings.

Chinese issuers, however, will have to improve their disclosure and corporate governance standards to meet the demands of the international investing community. Indeed, the China Securities Regulatory Commission has already promulgated regulations to raise the quality and level of disclosure. Stricter disclosure of financial information is now required for prospectuses, and companies must ensure they have independent directors. These rules will not only help China access foreign capital, but they will also set the foundation for building a more robust retail and institutional investor base in China.

China's WTO Commitments For Foreign Securities Firms

China's WTO commitments gave U.S. firms some greater market access. The commitments from China for the securities industry represented a first step upon which to pursue additional liberalization of China's capital markets. For example, there are provisions for minority ownership in local securities underwriting, asset management firms, and advisory companies. Particularly noteworthy are China's commitments for the securities sector that include the grandfathering of existing activities and investments, national treatment, and the elimination of China's "economic needs test." [5]

CHINA'S WTO COMMITMENTS TO FOREIGN SECURITIES FIRMS

- Participate directly in B share transactions *
- Eligible for special membership on Exchanges *
- Establish securities joint ventures (⅓ ownership) to underwrite A shares, and to underwrite and trade B and H shares and government and corporate debt
- Establish funds management joint venture (⅓ ownership *, 49 percent after three years.)
- Grandfather existing investments
- Eliminate economic means test
- Guarantee national treatment

* *upon accession*

In addition to its WTO commitments, China is taking other steps to open its markets. These include allowing foreign firms to list and issue local currency (renminbi) shares, and the establishment of foreign investment venture capital firms.

However, there remain significant market access barriers. SIA strongly urges China to make the following additional commitments—whether in the context of—the ongoing WTO financial services discussions, or in other trade forums:

Market Access

Permit foreign firms to set up a securities company in China, either through a wholly-owned entity or other business ownership structure, with power to engage in a full range of securities activities, including underwriting, secondary trading of government and corporate debt and A shares, etc. Firms should have the right to establish offices without geographical limitation. Similarly, permit foreign asset management firms to manage money for Chinese investors, both retail and institutional, as well as to sell internationally diversified mutual funds to individuals through qualified local distributors.

Qualified Foreign Institutional Investors (QFII)

China has take steps to open it's A-shares market to foreign investors adopting rules for Qualified Foreign Institutional Investors. Current QFII requirements are onerous, however, and limit the utility of the program. For example:

[4] Financial Liberalization and Financing Constraints: Evidence From Panel Data on Emerging Economies, Luc Leaven, World Bank, October 2000, http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/(attachmentweb)/wp002467/$FILE/wp002467.pdf.

[5] Governments often use economic needs tests to discourage new foreign direct investment, and take into account inter alia, the number of existing firms, level of competitions, and the size of the market as criteria in the process of granting a license to establish a commercial presence.

a. the requirement that a QFII commit at least $50 million equivalent (currently more than 1% of total market capitalization) in a special QFII account;
b. the limitations on QFII ownership, both individually and in the aggregate; and
c. the requirements that the principal amount in the QFII account remain in the account for at least one year (three years for closed-end funds), with subsequent remittances required to be approved by the State Administration of Foreign Exchange and principal withdrawal only permitted in stages.

We urge China to continue the process of making its securities markets more attractive to investment by abolishing the QFII regime in favor of a forward-looking policy encouraging unimpeded investment in the domestic market. We believe this would almost certainly result in greater foreign investment in China's securities markets, adding to the depth and breadth of trading in those markets and resulting in increased capital available to Chinese issuers.

In addition to market access constraints, the lack of a strong legal foundation in China further complicates the ability of U.S. firms and their clients fully to participate in the Chinese capital markets. An unwelcome level of regulatory risk characterizes China's business climate and acts as a severe tax on capital. A PriceWaterhouseCoopers' report measured the adverse effect of opacity on the availability of capital in 35 countries.[6] Not surprisingly, the report ranked China at the bottom with an opacity score equivalent to an additional 46 percent corporate income tax.[7] China also placed last in legal and judicial opacity, as well as regulatory uncertainty and arbitrariness.

If China is to sustain long-term economic growth and continue to attract the foreign capital it needs, it must improve its legal infrastructure. Greater transparency will be a critical part of improving the rule of law in China. Transparent and fair regulatory systems play an integral role in the development of deep, liquid capital markets that, in turn, attract market participants, increase efficiency, and spur economic growth and job creation. A high level of transparency also ensures that foreign firms are accorded national treatment. Perhaps most importantly, transparency enhances investors' trust and assists international capital flows. Lack of transparency in the implementation of laws and regulations can seriously impede the ability of securities firms to compete.

The China Securities Regulatory Commission's (CSRC) promulgation of draft Joint Venture Rules for securities firms illustrates this point. While we appreciate that the CSRC sought public comment on its joint venture regulations, we note that the proposed rules were issued on December 12, 2001, with a deadline for comment on December 31, 2001. In addition, we note that the CSRC's draft provisions for foreign equity investment in fund management companies were issued on December 21, 2001 with a comment deadline of December 31, 2001. Such truncated comment periods are clearly insufficient for complex new regulations and particularly in cases where the regulations were specifically targeted at non-domestic firms.

SIA has published a paper (Appendix I) that serves as a blueprint for a transparent regulatory regime. The paper underscores the key guiding principles of fair and transparent regulations as follows: 1) rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified; 2) regulation should be enforced in a fair and non-discriminatory manner; 3) regulations should be clear and understandable; 4) all regulations should be publicly available at all times; and 5) regulators should issue and make available to the public final regulatory actions and the basis for those actions, in order to enhance public understanding thereof.

We also note an American Chamber of Commerce in China White Paper[8] that commented on the importance of regulatory transparency. The Chamber notes that while progress has been made, "[f]oreign investors are adversely affected by the promulgation of regulations without prior notice, opportunity to comment, or contemporaneous issuance of implementing regulations." Moreover, according to the Cham-

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[6] PriceWaterhouseCoopers, The Opacity Index, January 2001. Opacity is based on 5 different factors that impact capital markets: 1) corruptions; 2) legal systems; 3) government and macroeconomic and fiscal policies; 4) accounting standards and practices (including corporate governance and information release); regulatory regime.

[7] The study uses Singapore as the benchmark, so that an increase in opacity from the Singaporean level to the Chinese level has the same negative effect on investment as raising the tax rate by 46 percent.

[8] 2002 White Paper on American Business in China, March 2002.

ber, "At present, laws and regulations are only sporadically released in draft form for public comment, and after promulgation are identified only by their name and, in many cases, chronological and numerical sequence by issuing department. This deprives foreign investors, traders, and other interested parties of opportunities to comment, and makes keeping track of existing laws and regulations very cumbersome and expensive." Also rules and regulations on bankruptcy and intellectual property rights, among others, must be clear, fairly applied and enforceable. The development of such rules and regulations will attract and improve access to financing.

Continued liberalization of China's capital markets has clear benefits for China and the global economy. It is a long-established U.S. policy to promote economic growth through open financial services markets. Global economic integration facilitates the importation of capital and intermediate goods that may not be available in a country's home market at comparable cost. Similarly, global markets improve the efficient allocation of resources. Countries gain better access to financing, and the suppliers of capital—institutional investors or individual savers—receive better returns on their investments.

Finally, open, fair markets help increase living standards. We look forward to working with the Congress and the Administration to further expand the U.S. securities industry's access to China through the use of bilateral and multilateral trade forums.

Attachment

PROMOTING FAIR AND TRANSPARENT REGULATION

DISCUSSION PAPER

I. Setting The Foundation for Open and Fair Securities Markets

Deep and liquid capital markets are the essential building blocks of today's economy, supplying the funds for economic growth and job creation. The firms that participate in the markets price risk, allocate capital, provide investors with advice and investment opportunities, and supply the liquidity needed to make markets work efficiently.

Just as capital markets underpin economic growth and job creation, transparent and fair regulatory systems are essential to the development of deep and liquid capital markets. A system of regulation that is transparent to market participants instills the confidence needed to attract both the suppliers and users of capital to make the best use of the markets.

Governments, regulators and the international financial institutions have undertaken substantial projects designed to improve the quality of the financial systems world-wide. Attention is now focused on building fair and transparent regulatory systems—grounded in the principles of market integrity and investor protection—to oversee those markets. Consistent with those goals and the principles of prudential regulation, discriminatory practices and considerations, such as the nationality of individuals or the place of origin of firms, should not be permitted to influence regulatory policies or actions.

This paper is based on the assumption that a country's relevant laws should promote fair and transparent regulation. The principles outlined in this paper are not intended to prevent a regulator from taking measures for prudential or legitimate public policy reasons recognized under the World Trade Organization, including protecting investors, ensuring that markets are fair, efficient and transparent, and reducing systemic risk.

A consensus view, supporting the development of active, sound and efficient markets based upon established principles for capital market regulation, is rapidly emerging. In September 1998, the International Organization of Securities Commissions (IOSCO) issued a paper entitled "The Objectives and Principles of Securities Regulation" that urged the adoption by all regulators of processes and regulations that are:

- consistently applied;
- comprehensible;
- transparent to the public; and
- fair and equitable.

The International Monetary Fund ("IMF") is developing a broad-based "Code on Good Practices and Transparency in Monetary and Financial Policies" that complements IOSCO's work.

The securities industry, which today operates on a global basis, supports the IMF and IOSCO efforts to establish principles of fair and transparent regulation. The securities industry strongly believes that by making regulation and the operation of regulators accessible and transparent and by treating foreign and domestic licensed market participants fairly and equitably, governments, regulators and international financial institutions will promote the best markets for investors throughout the world.

Building on the emerging regulatory consensus, this paper provides the views of the securities industry on fundamental regulatory principles and practices that will provide a fair and level playing field for market participants. It also sets the foundation for building strong and vibrant markets worldwide. Moreover, we strongly believe that the principles promoting fair and transparent markets are broadly applicable to all financial services firms participating in the global capital markets. In this regard, we are actively seeking the support of financial services firms worldwide in promoting these principles.

II. Guiding Principles of Fair and Transparent Regulation

A. *Rules, regulations and licensing requirements should be considered and imposed, and regulatory actions should be taken, only for the purpose of achieving legitimate public policy objectives that are expressly identified, including, for example, investor protection, maintaining fair, efficient, and transparent markets, and reducing systemic risk.*

B. *Regulation should be enforced in a fair and non-discriminatory manner.*

1. *Regulations and regulators*[1] *should not discriminate among licensed market participants on the basis of the nationality or jurisdiction of establishment of the shareholders of a market participant or the jurisdiction of establishment of any entity that owns or controls the equity or indebtedness of a market participant.*
2. *The relationship between a regulator and a licensed market participant should be governed by the standards set forth in relevant rules and regulations, and should not be subject to political or other extraneous or improper considerations.*
3. *The introduction of new securities products and services by firms should be governed by the standards set forth in relevant rules and regulations*

C. *Regulations should be clear and understandable.* Clear and understandable regulations and rulings provide market participants with the predictability and necessary knowledge to comply with regulations. Opaque or ambiguous regulations and rulings create uncertainty among investors and licensed market participants.

D. *All regulations should be publicly available at all times.* All regulations should be made, and at all times remain, publicly available, including requirements to obtain, renew or retain authorization to supply a service. Disciplinary actions should not be taken based on violations of regulatory standards that were not in effect at the time the relevant activity took place.

E. *Regulators should issue and make available to the public final regulatory actions and the basis for those actions, in order to enhance public understanding thereof.*

III. Rulemaking and Implementation

A. *The rulemaking process*

1. *Regulators should utilize open and public processes for consultation with the public on proposals for new regulations and changes to existing regulations.* A reasonable period for public comment should be provided. Any hearings at which formal promulgation or adoption of new regulations or changes to existing regulations are considered, if open to a member of the public, should be open to all members of the public. Regulators should not take arbitrary regulatory action against those who participate in the consultation process.
2. *In considering whether rules, regulations, licensing requirements or actions are necessary or appropriate, regulators should also consider, in addition to*

[1] The term "regulator" is intended to cover all bodies that are authorized pursuant to law to play a role in the licensing and supervision of the activities of financial services firms, as well as the bodies that formulate rules, regulations and policies relating to such firms. Where the legislature or authorized regulator delegates its authority to a non-governmental entity such as a self-regulatory organization or trade association, the term is intended to encompass such an entity.

the protection of investors, whether the action will promote efficiency, competition and capital formation.

B. *Communicating and implementing new rules*

1. *New rules and regulations that provide advice for market participants should be made available to them and the public in a timely and efficient manner.* Such changes should be made available, in writing, by electronic media or other means of distribution so that all market participants have reasonable access to such material.
2. *Market participants should be given a reasonable period of time to implement new regulations.* The effective date of a new regulation should provide a reasonable period for market participants to take the steps needed to implement the new regulation under the circumstances.

C. *Interpretations of rules*

1. *Regulators should establish a mechanism to respond to inquiries on rules and regulations from market participants.* The titles and official addresses of the relevant regulatory offices should be provided.
2. *Interpretations and the grants or denials of regulatory relief or exemptions should be made available to the public.* Such interpretations, relief or exemptions should generally apply or should be applied upon proper request, to substantially similar licensed market participants and new products. Under limited circumstances it may be appropriate to delay the publication of individual grants of relief for reasonable periods of time to address legitimate competitive concerns.

IV. Licensing and new Product Procedures

A. Procedures for licenses and introduction of new securities products and services.

1. *Criteria governing licensing of firms and the introduction of new securities products and services by firms should be in writing and accessible, and should be the basis on which decisions are made.* All regulations and related explanatory materials governing the consideration and issuance of licenses to firms and the introduction of new securities products and services by firms should be reduced to writing and made publicly available to potential applicants upon request. No licensee should be denied a license, and no new securities product or service should be prohibited, on the basis of any factor not identified in such written regulations or explanations.
2. *The introduction of new securities products and services by firms should be governed by the standards set forth in relevant rules and regulations.* Where particular requirements are established in connection with the introduction of a product or service, such requirements should govern the introduction of complying products and services. In order to promote flexibility and efficiency in the capital markets, such standards and requirements should enable firms, to the maximum possible degree consistent with principles of prudence and investor protection, to introduce complying new products and services on the basis of sound internal procedures for compliance without additional regulatory review.
3. *Information supplied by applicants as part of an application process should be treated confidentially. Such information should be disclosed only in accordance with existing rules permitting public disclosures, such as those that may be triggered by the granting of a license or product approval.*
4. *Regulators should promptly review all applications by firms for licenses and required product or service approvals and should inform the applicant of any deficiencies.* No application for a license or approval that provides all information required pursuant to regulation and is made in good faith by an applicant that meets required criteria should be refused review and action by the relevant regulator. Action on all applications received should be taken within a reasonable period. Licenses should enter into force immediately upon being granted, in accordance with the terms and conditions specified therein.
5. *Where an examination is required for the licensing of an individual, regulators should schedule such examinations at reasonably frequent intervals.* Examinations should be open to all eligible applicants, including foreign and foreign-qualified applicants.
6. *Fees charged in connection with licenses and the introduction of new securities products and services should be fair and reasonable and not act to pro-*

hibit or otherwise unreasonably limit licensing requests or the introduction of new product and services.

B. *Licensing of entities and their employees*

1. *An applicant's competence and ability to supply the service should be the criteria used for licensing entities and employees.* The terms and conditions for granting licenses should be made explicit, including education, experience, examinations and ethics. Procedures and criteria should not unfairly distinguish between domestic and foreign applicants. In addition, there should be no quantitative limits on the number of licenses to be granted to a particular class of market participants who are otherwise qualified.
2. *When imposing licensing requirements, regulators should endeavor to give consideration to comparable testing or other procedures confirming the qualifications of an applicant that already have been completed in another jurisdiction.* The ability of qualified and experienced market professionals to provide services in a foreign jurisdiction may be promoted where testing or other procedures used in the professional's home jurisdiction may satisfy all or part of the foreign jurisdication's licensing requirements.

C. *Denials of licenses and product and service approvals*

1. *When denying an application for a license or a required securities product or service approval, regulators should, upon request, provide an explanation for that action.* Any total or partial denial of any application for a license or a required new product or service approval should, upon request, be accompanied by a written statement of explanation from the relevant regulator detailing the reasons for the denial, including the particular requirements of the regulations governing the issuance of such license or required approval that were not satisfied. Applicants should be given the opportunity to resubmit applications or to file additional or supplementary materials in support of their applications.
2. *Applicants should be afforded meaningful access to administrative or judicial appeal of a denial of a license or a required product or service approval (or failure to act on an application).*
3. *An appeal of a denial of a license or a required product or service approval should be decided within a reasonable time period after the appeal is filed*. An applicant's decision to pursue an appeal (whether formal or informal) should not prejudice its existing licensed operations.

V. Implementation of Regulatory Standards

A. *Inspections, audits, investigations and regulatory enforcement proceedings* [2]

1. *All inspections, audits, investigations and regulatoryenforcement proceedings should be conducted pursuant to established regulatory and judicial standards and should not arbitrarily discriminate based on improper or other extraneous criteria like nationality*.
2. *All inspections, audits, and investigations should be conducted in a manner that does not impinge on the rights of licensed market participants and their directors, officers and employees.*
3. *A regulatory authority* [3] *should not publicly disclose the fact that it is conducting an enforcement related inspection, audit or investigation of a particular entity until a determination has been made by the regulatory authority to take remedial or other enforcement-related action, unless otherwise subject to a legally enforceable demand unless made in connection with a generally applicable disclosure requirement imposed on the entity*. The inspection, audit or investigation should be conducted at all times with due attention to the privacy and confidentiality concerns of all affected parties, including licensed market participants, their directors, officers, employees, and clients.

B. *Regulatory proceedings to impose a sanction*

[2] The term "regulatory enforcement proceedings" means administrative or judicial action authorized by the relevant regulatory authority and is intended to cover civil, administrative or criminal proceedings that involve a financial services firm and/or its employees based on their financial services activities.

[3] The term "regulatory authority" is intended to cover all regulatory bodies involved in the inspection, auditing, investigation or prosecution of the activities of financial services firms. Depending on the system, the term may encompass criminal and judicial authorities as well as non-governmental entities such as self-regulatory organizations.

1. Notice and opportunity to be heard
   a. *Notice of applicable law and regulation*. A regulatory proceeding to impose a sanction should only be instituted based on the violation of laws or regulations that were in effect at the time that the relevant activity occurred and where the subject of the proceeding had timely notice of them.
   b. *Notice of determination to take action*. Licensed market participants should be notified in a timely manner both when: 1) a determination has been made to hold a regulatory proceeding concerning the conduct of that participant; and 2) a decision in, or on the status of, that proceeding has been made.
   c. *Opportunity to be heard*. Except in situations where emergency temporary relief is necessary, in all regulatory proceedings, licensed market participants should be given a reasonable opportunity to be heard and to submit, on the record, position papers and other documentary evidence.
2. Representation by counsel and access to evidence
   a. *Right to legal counsel*. The subjects of a regulatory proceeding should have the right to have legal counsel of their choice represent them in all meetings with, and interviews by, regulatory authorities. A regulatory authority should not suggest or imply that the attendance of counsel will in any manner alter the character of the proceedings being conducted, the level of supervisory review to be undertaken, or the manner in which the regulatory authority carries out its functions.
   b. *Access to evidence*. The subjects of a regulatory proceeding should, upon request, be permitted reasonable access to all documents and records that are relevant to the subject matter involved in the pending regulatory action. Documents and records to which access is denied based on privileges generally recognized in such proceedings should not be admissible in evidence in such regulatory proceeding.
   c. *Burden of proof*. The burden of proof to demonstrate that a licensed market participant has not conducted its business in accordance with the relevant law and regulation should rest with the regulatory authorities.
3. Sanctions and Appeals
   a. *Sanctions.* Sanctions by a regulatory authority should be imposed in a fair and nondiscriminatory manner based on the relevant facts and with an effort to treat similarly situated persons and entities in a similar manner. The basis for any decision to impose sanctions by a regulatory authority should be explained in a writing that is made available to the subjects of the proceeding.
   b. *Appeals.* The subjects of a regulatory proceeding should have available to them a forum for appealing the decisions rendered and sanctions imposed. The body considering a particular level of appeal should be separate from that which made the decision or imposed the sanction that forms the basis of the appeal. Appeals to a regulatory authority should be decided in a timely manner and appeal determinations should be explained in a writing that is made available to the subjects of the proceeding.

Statement of the Semiconductor Industry Association

The Semiconductor Industry Association (SIA) is pleased to submit written comments regarding U.S.-China economic relations and China's role in the global economy. The SIA represents the $70 billion U.S. semiconductor industry. U.S. semiconductor firms are leading global competitors, commanding a 50 percent world market share.

China represents a large and growing market for semiconductors and other information technology products. In fact, semiconductors are the second largest U.S. export to China. Over the past decade, SIA was a strong supporter of legislation to provide Permanent Normal Trade Relations with China as part of China's entry into the WTO, and SIA is pleased that the Chinese Government has taken a number of positive steps in implementing its WTO obligations. However, several areas will require continued efforts by the Chinese Government in order to fulfill the commitments made under WTO accession. SIA's submission will only elaborate on those issues of special relevance to American semiconductor producers, including China's value added tax (VAT) rebates for domestically produced chips, semiconductor intellectual property, transparency, and local content. The VAT rebate issue is of particular concern to SIA members. Earlier this week, SIA released a study of China's emerging semiconductor industry which, among its conclusions, finds the VAT rebate scheme distorts trade and investment, and imposes a cost penalty for semiconductor importers trying to compete for sales in China.

CHINA MARKET

In 2001 the Asia Pacific region, driven primarily by growth in China, surpassed the U.S. as the largest semiconductor market in the world. In terms of demand, in 1997, the U.S. represented 33 percent of the world market, while the Asia Pacific region represented 22 percent. Five years later, in 2002, the Asia Pacific share had grown to 36 percent, compared to the U.S. share of 22 percent—a reversal of positions. By 2005, the U.S. is projected to be the smallest of the four regional markets,[1] representing only 18 percent of the world, less than half of the 40 percent share that the Asia Pacific market is projected to represent. The growth of the Asia Pacific market has been driven by the growth in China. China's $18 billion integrated circuit market represented 15 percent of total world demand in 2002, up from 7 percent of the world in 2000.

China's semiconductor market growth is occurring within the context of significant growth in China's computer and telecommunications markets. China is now the world's largest mobile phone market, and second largest personal computer market.

Currently domestic Chinese production, including foreign owned facilities in China, meets only about 15 to 20 percent of its market demand, with the remaining 80 to 85 percent met by imports. The Chinese Government's Tenth Five Year Plan, covering 2001–2005, has an ambitious target to ensure that by 2005 "60 percent of IT products should be home grown," and that China shall "gradually design and develop its own IC products, (including [central processing units])."

SIA'S EFFORTS IN CHINA

SIA has been encouraging an open trade environment in China for over a decade. SIA has sent delegations to China since the early 1990's to meet directly with Chinese Government and industry officials to discuss **the benefits of market liberalization to China's economic growth and to U.S.-China relations**. SIA provided advice to the U.S. government on the WTO accession issues of importance to the semiconductor industry and, as noted earlier, was an active supporter of legislation to allow Permanent Normal Trade Relations with China.

Based on SIA's interactions with senior Chinese Government officials, we believe that there is a **genuine commitment expressed by all Chinese officials to full and faithful execution of China's WTO obligations**.

SIA was pleased that China became a signatory of the WTO's Information Technology Agreement (ITA) in April 2003, committing to eliminate tariffs on a range of information technology products. SIA has long supported the elimination of semiconductor tariffs, beginning with the suspension of U.S. tariffs in 1985, because tariffs increase costs to consumers and thus impede the ability of consumers to take advantage of semiconductor technology. SIA was an early supporter of the ITA, and China's joining this agreement was a high priority because of the consumer benefits that would flow from the elimination of tariffs on semiconductors, computers, telecommunications equipment, and semiconductor manufacturing equipment. **The elimination of China's 6 to 12 percent semiconductor tariffs in January 2002, contributed to a reduction in smuggling and** resulting shift to legitimate import channels, better positioning U.S. companies to take advantage of trading rights when they are fully phased in at the end of 2004 (three years after accession). SIA was pleased that China was able to resolve the "end use" certification issue that had initially prevented its formal participation in the ITA. China had imposed "end use" certification requirements on 15 ITA products, that were inconsistent with the ITA, and would have created a dangerous precedent, especially as we sought to expand the ITA to additional countries. SIA is pleased that China is now a full participant in the ITA, and we appreciate the efforts of USTR that led to this result.

VALUE-ADDED TAX

China imposes a value-added tax (VAT) of 17% on sales of all imported and domestically-produced semiconductors and integrated circuits. However, current Chinese Government policy provides for a rebate of the amount of the VAT burden in

[1] The four regions are North America (primarily the U.S.), Europe, Japan and Asia Pacific.

excess of 6% for integrated circuits manufactured within China (and the amount of the VAT burden in excess of 3% for integrated circuit designs developed in China).[2] **This discrimination against imported semiconductors through the VAT rebate is inconsistent with China's WTO obligations**.

Reduction of the semiconductor VAT should apply to all semiconductors and integrated circuits sold in China (whether domestically-produced or imported). Application of the VAT reduction to all companies would allow China to come into compliance with its WTO obligations to refrain from discrimination against imports while maintaining its commitments to investors in domestic facilities of a reduced VAT rate.

GATT Article III (on "National Treatment") establishes a general prohibition against a WTO member engaging in activity that discriminates in favor of domestic products at the expense of imported products. Specifically, paragraph 2 of this article states that a WTO member cannot impose taxes on imported products that are greater than those imposed on domestic products. By rebating the amount of the VAT burden over 3% or 6% for local products, while continuing to impose the full 17% VAT on imported semiconductors, the current policy violates this basic GATT/WTO obligation.

Prior GATT decisions clearly establish that it is a violation of the national treatment principle to grant a tax credit or rebate to certain domestic manufacturers of a product while charging the full tax rate to similar foreign-manufactured products. This is true even if the tax credit or rebate is intended to provide a subsidy to local producers. While China does provide the benefits to both domestic and foreign-owned facilities in China, the different treatment of domestic and imported products is a violation of its national treatment commitment. Any tax imposed on imported goods must be collected in a non-discriminatory manner.

The best solution for U.S. export interests and the development of China's information technology market is for the PRC to reduce or eliminate the VAT rate for all semiconductors and integrated circuits, regardless of origin.

As noted above, China joined the Information Technology Agreement (ITA) and has eliminated all tariffs on semiconductors in 2002 and will eliminate tariffs on other information technology products in the near future. The same public policy reasons that caused China to decide to eliminate its tariffs on semiconductors apply with equal force to a decision to lower the VAT rate. A substantial portion of the growth of the American economy has been attributed to information technology and the productivity enhancements made possible by advances in semiconductor technology and production. Just as it was in China's interest to eliminate all import tariffs on semiconductors, significant reduction in the VAT rate imposed on all semiconductors would contribute to the growth of the Chinese IT market and would benefit the Chinese economy in general. In addition, reports indicate that China's elimination of semiconductor tariffs (formerly 6–12%) has succeeded in reducing smuggling of semiconductors into China. As the high VAT rate on semiconductors provides an incentive for smuggling, this runs counter to the high priority the Chinese Government has placed on eliminating illegal entry of goods.

Although it is not designed to do so, the high VAT rate imposed on semiconductors imposes significant costs on Chinese electronics producers on exports from China. While China ostensibly rebates the VAT on semiconductors and other electronics components when the finished product containing the inputs is exported, many exporters from China have been unable to receive the full amount of the rebate officially due to them because provincial and local authorities may refuse to rebate VAT charges collected by another jurisdiction within China.

There have been several noteworthy developments on the VAT rebate issue this year. **First, there is the growing recognition in Washington as well as in other world capitals that China's VAT rebate program is a violation of the WTO.** In March, **32 Members of the U.S. House of Representatives** sent a letter to Ambassador Zoellick stating "We believe China should eliminate the VAT for all semiconductors regardless of origin and we encourage you to continue to press for a speedy resolution of this violation." In June, **21 U.S. Senators** sent Amb. Zoellick a letter stating "We urge you to continue to vigorously insist that China lower its VAT on semiconductor imports to abide by its World Trade Organization (WTO) commitments . . ." Many of you on the Committee signed these letters, and we appreciate the continued support of Congress on this issue.

In May, the World Semiconductor Council (WSC) issued a joint statement critical of China's VAT rebate program. The WSC is composed of CEOs from companies representing the European Semiconductor Industry Association (EECA–ESIA), Japan Electronics and Information Technology Industries Association

[2] State Council Document Number 18, June 2000

(JEITA), Korea Semiconductor Industry Association (KSIA), Semiconductor Industry Association (SIA), and Taiwan Semiconductor Industry Association (TSIA). The WSC stated:

". . . under China's current application of its Value Added Tax (VAT), a VAT of 17% is applied to all semiconductors, but companies designing and manufacturing semiconductors in China are eligible to receive a substantial rebate of the VAT paid on those semiconductors. This reduces the effective VAT burden on domestically designed and produced semiconductors to only 3%. Discrimination has the effect of limiting market access, distorting patterns of trade and investment, and negates the benefits China promised to provide when it joined the WTO. The WSC calls for China to lower its VAT rate to 3% for all semiconductors, regardless of origin."

A second key development is USTR's formal inquiries to the Chinese on this subject. Coupled with the interest on Capitol Hill and the WSC, USTR's request that China address the VAT rebate problem has attracted the attention of Chinese Government officials. **As a result of this attention, China has formed a research group to re-examine the VAT issue. In SIA's recent meetings in China, we sensed a willingness in some quarters to explore alternatives with the U.S., but in other quarters, continued skepticism that changes were necessary. The U.S. government must continue to insist that China quickly come into compliance with GATT article III.**

In the most recent development, SIA released a report this week entitled, "China's Emerging Semiconductor Industry—The Impact of China's Preferential Value-Added Tax on Current Investment Trends." The study finds that China's VAT rebate puts pressure on foreign semiconductor makers to design and manufacture their products within China, or face a cost penalty. As a result, the VAT policy is driving investment to China that may otherwise not occur. Copies of the new SIA study have been distributed to Ways and Means staff, and it may be downloaded from www.sia-online.org.

Lowering the VAT for both domestically produced and imported semiconductors would be a non-discriminatory policy that is in China's interest for all the reasons set forth above. Non-discriminatory application of the VAT rebate for all semiconductors would allow Chinese electronics producers to obtain the most advanced technology available worldwide at the most competitive prices, benefiting Chinese consumers and the entire Chinese economy, as well as encouraging growth in China's IT sector.

INTELLECTUAL PROPERTY PROTECTION

SIA would like to underscore the importance of China's full compliance with its commitments to improve intellectual property (IP) protection. This is critical not only to U.S. firms doing business in China, but also in China's self interest, as it will encourage the high technology foreign investment China seeks in order to promote the development of its economy while simultaneously encouraging local entrepreneurs to engage in innovation.

Before discussing the issue of enforcement, let me begin by congratulating China for its success in resolving one issue related to its semiconductor layout design protection law. In March 2001, China's State Council passed Regulation on Integrated Circuit Layout Design Protection, which took effect October 1, 2001. Last year, a senior official of the Ministry of Information Industry made comments indicating that China's new law did not cover discrete semiconductors. SIA objected to this interpretation because the WTO TRIPs agreement is clear that discretes, which are products with only one active element, are to be protected. We are pleased to report that, in a response to a question posed by the United States, China affirmed before the Council for Trade-Related Aspects of Intellectual Property Rights that "With respect to discrete mentioned in the question in particular, if it complies with provisions of Article 2 and Article 4 of the Regulations on the Protection of Layout Designs of Integrated Circuits, it can be protected through applying for registration of layout-design."[3] **We believe that this resolves the discretes issue, and again express our appreciation the USTR and Chinese Government for their efforts to bring this question to a satisfactory conclusion.**

SIA would like to highlight the need for strengthened IP enforcement. IP protection is important not only in China, but in all markets around the globe. The **World**

[3] Council for Trade-Related Aspects of Intellectual Property Rights; Responses from China to the Questions posed by Australia, the European Communities and their member States, Japan and the United States; IP/C/W/374 10 September 2002; Page 43.

Semiconductor Joint 2003 Statement, referenced above, emphasized the need for strong intellectual property protection around the world, stating:

> *"Semiconductor makers must invest a very high percentage of sales in R&D, and the intellectual property that results is the lifeblood of the company. Failure to adequately protect intellectual property is very damaging to the semiconductor industry. There are an increasing number of instances of counterfeiting of IC's and other semiconductors. One form of counterfeiting is the unauthorized direct optical copying of the chip, and reproduction of a mask work (layout design/topography) based on the optical copying, and then fabrication of a semiconductor based on this mask work and sale under a different company's name. Another form of counterfeiting involves reverse engineering a company's chip, and then producing a physically identical chip and selling it without authorization under the original company's name and trademark.* ***Both types of counterfeiting must be quickly addressed and stopped."***

The World Semiconductor Council is now working on a proposal to establish fast track consultative mechanisms to encourage enforcement actions to counter IP violations, and to encourage manufacturers to develop policies to prevent their inadvertently making semiconductors that violate a third party's IP. We are hopeful that this proposal will be adopted in all semiconductor producing regions around the world.

SIA is aware of numerous reports of IP violations in China. In one typical case, an SIA member company found that Chinese firms were making identical copies of its chips and data sheets, and selling it under the Chinese company's name. Under TRIPs, reverse engineering a chip to design an original and better product is allowed under the layout design laws. However in this case the chips were essentially photocopies of the U.S. design, which we know because the pirate included the U.S. company's part number etched in a submask level and unused circuits that the U.S. firm had placed on the chip to reserve space for future product development. The Chinese firms that engage in piracy are typically thinly-capitalized companies that contract the manufacture of the copied chips to foundries that can afford to make the necessary capital expenditures.

China's court system is still developing, and U.S. firms are concerned about the fairness of its procedures. For example, we understand that only "legitimate" purchases are actionable. These rules put an unreasonable burden on U.S. firms who cannot hire a private investigator to purchase the counterfeits, but must instead find purchasers of the counterfeit product and convince those purchases to sign a statement that they bought the counterfeit goods. China also has administrative enforcement mechanisms, but these are largely untested.

In the aforementioned letter signed by 32 House members, the Representatives stressed that "the improved laws China put in place to protect IP are useless unless they are supported by transparent, standardized and predictable court procedures that make the judicial system accessible . . . **We must continue to demand that China immediately upgrade its IP enforcement mechanisms so that foreign semiconductor companies have certainty their products are protected in this emerging market."** The letter signed by 21 Senators to Ambassador Zoellick stated "We encourage you to continue to press for strengthened enforcement to bolster the credibility of [the IP] laws, and to **explore with your Chinese counterparts alternative solutions such as fast track investigations of alleged piracy**." Given its importance to both U.S. producers and China's economic development, SIA urges USTR and the Chinese Government to continue to make IP enforcement a high priority issue.

TRANSPARENCY

Several commitments in the final protocol of accession are expected to improve transparency in China's administrative rule-making. For example, China has agreed that only those trade-related measures that are published and readily available will be enforced. China has also agreed to make information on trade-related measures available to WTO members upon request before those measures are implemented or enforced.

Additionally, **China has committed to establish or designate an official journal for the publication of all trade-related measures and to provide a reasonable period of time for comment to the appropriate authorities before measures are implemented**. China is considering providing this information in English in order to provide transparency to the international business community, and to post the information on the web. These are important steps in improving transparency. SIA urges China to fully implement these measures.

LOCALIZATION

There had been localization requirements for parts and materials for products made in China which, while not technically legal requirements, imposed serious restrictions on firms' ability to utilize imported parts. Firms had been required to file localization plans with their foreign investment application. The Chinese Government also audited foreign firms to determine local content. What constitutes local content can be subject to many definitions. For example, importation via a Chinese distributor can qualify a part as "local." Chinese sectoral industrial policies also contain local content requirements. Prior to its accession to the WTO, China had imposed local content requirements on products containing semiconductors.

In our discussions with Chinese officials, there was a recognition that these policies are inconsistent with China's WTO obligations and would be repealed in time. **SIA again calls for the immediate repeal of all local content policies as required by the terms of the WTO accession agreement.**

During the China WTO accession negotiations, the Chinese Government confirmed that **China would ensure that all state-owned and state-invested enterprises would make purchases and sales solely on commercial considerations**, e.g. price, quality, marketability, availability, and that the enterprises of other WTO members would have an adequate opportunity to compete for sales to these enterprises on a non-discriminatory basis. In addition, the Chinese Government committed that it would not influence commercial decisions on the part of state-owned or state-invested enterprises. Adherence to these commitments will be critical for China's development because it will ensure that Chinese electronics firms are able to purchase the most competitive chips free from political interference. Given the market access problems that the U.S. historically faced in other semiconductor markets, it is also critical to U.S. export interests that China's state-invested enterprises purchase solely on a commercial basis.

CONCLUSION

China is a large and fast growing market. The economics of our industry dictate that U.S. firms, to remain competitive, must be able to compete on a fair and open basis for sales in China. For this reason, we are very encouraged by China's efforts to implement its WTO commitments, but we are concerned over the remaining existence of barriers and impediments to trade in China. While the challenge of promoting economic development in a country the size of China is immense, we are encouraged by China's progress and are hopeful that China will lower its VAT for all semiconductors, vigorously enforce its IP laws, eliminate its local content requirements, and improve transparency.

SIA thanks the Ways and Means Committee for the opportunity to submit written comments for today's hearing on "United States-China Economic Relations and China's Role in the Global Economy." We look forward to continuing to work with the U.S. government on these important issues.

Statement of the Honorable Jim Slattery

Thank you, Mr. Chairman, for the opportunity to bring to this Committee's attention a matter that I believe is central to the future of the trade relationship between the United States and China. This hearing is focused on ensuring that China is integrating itself into the rules-based trading system that governs all WTO members. However, there is another rules-based system of law to which China must adhere if it is to obtain the foreign capital, technology, and expertise it needs.

Simply put, China cannot reach its economic potential until it consistently applies the rule of law and due process of law to foreign companies and investors doing business in China. Government entities cannot seize private property without promptly and adequately compensating the rightful owner. That rule of law is generally recognized among all our trading partners. As I will explain, it is not the case today in China, especially where high government officials are involved in seizing private property for their own ends. This situation should concern the Committee as it poses a threat to U.S. and other foreign investors considering investments in China.

In an effort to gain control over the first company in China in half a century to be listed on the New York Stock Exchange, Governor Bo of Liaoning Province directed the seizure of the true owner's interests in the company. The owner, an entrepreneur named Yang Rong, had taken the company, Brilliance China, from being a profit loser to become the largest minibus producer in all of China. He is a resident green card holder in the U.S., and his wife is an American citizen. The corporate directors who cooperated with this illegal seizure were paid handsomely with call options later exercised for a value of $15 million for each director.

Mr. Yang Rong, sought due process of law in the Beijing Courts. However, this effort was thwarted because the provincial government notified the court in Beijing that Yang Rong was accused of unspecified "economic crimes." The alleged crimes were never specified. It did not matter; the mere suggestion of possible criminal conduct was sufficient to cut off Mr. Yang Rong's due process rights in Beijing. Under Chinese law, civil cases must defer to consideration of criminal cases, so the case was transferred from Beijing to the province. At that point, Mr. Yang Rong, out of concern for the safety of himself and his family, moved to the United States.

He also sought due process of law in Bermuda, where China Brilliance was incorporated. The case is still proceeding there. Now, with the assistance of my law firm, Wiley, Rein & Fielding, he has brought a case in the U.S. District Court for the District of Columbia under the Foreign Sovereign Immunities Act. The central government has so far declined to serve the complaint on the Liaoning Provincial Government. That, however, will not prevent this case from proceeding.

Mr. Yang Rong's experience sends a very powerful negative signal to U.S. businessmen and investors. The message to foreigners is that while the central Chinese Government strives to attract foreign investments, a provincial governor, like Governor Bo in Liaoning Province, can expropriate them without due process of law.

This issue has attracted considerable attention in the international press. The reason is because millions of Chinese and foreign investors realize two things. First, due process of law is vital to China's progress in attracting foreign investment. Second, there is no clearer test of the vitality of the rule of law in a government than where someone with influential friends and relatives is accused of illegally taking private property without compensating the lawful owner.

I am happy to supply any Member with additional information about this fascinating case. Hopefully, China will learn that to attract investment, the rule of law and due process of law must be applied impartially to everyone—citizens and foreigners, from the lowest to the highest persons.

Statement of the Society of the Plastics Industry, Inc.

The Society of the Plastics Industry, Inc. (SPI) is pleased to submit comments to the House Ways and Means Committee for the October 30–31, 2003, hearings on U.S.-China Economic Relations and China's Role in the Global Economy. SPI applauds the Chairman and the committee for addressing this critical issue.

Founded in 1937, SPI is the primary plastics industry trade association representing the entire plastics industry supply chain which includes plastics products processors, manufacturers of machines and molds, and raw material (resin) suppliers. The plastics products industry is the nation's fourth largest manufacturing segment and can be found in every state. The U.S. plastics industry provides products that impact and enhance every aspect of our lives.

Plastics is a dynamic industry that has grown more rapidly than overall manufacturing for the past 25 years. It has continued to adapt to meet the ever-growing needs of consumers and to meet ever-changing economic challenges. Employment in the plastics industry grew 2.2% per year between 1980 and 2001. Real value added in the industry grew 3.7% per year from 1980 to 2001. The value of shipments grew 3.3% per year from 1980 to 2001.

Plastics industry growth rates slowed significantly in terms of shipments, employment and number of establishments towards the end of the 1990s and into 2001. This slowdown mirrored what happened to the rest of manufacturing for various reasons including rising energy costs, the high value of the dollar, and the bursting of the 1990s "tech bubble." The industry gets a double hit from high energy prices: plastics resins are made from natural gas, and the manufacturing process is energy intensive. The industry slowdown accelerated in 2001.

Today the industry is facing especially difficult times, having been hard hit over the past several years during the nation's economic slowdown and by policies that have put U.S. manufacturing at a disadvantage in the global marketplace.

These policies make it more expensive to manufacture products in the U.S. at a time when the resultant cost increases cannot be passed on in the form of price increases in products that are competing in the global marketplace. Such market conditions force U.S. companies to make tough decisions, such as whether to relocate outside of the U.S. in order to compete or lay off employees.

The U.S. plastics industry in 2002 employed some 1.4 million workers and shipped $309 billion in raw material, products and equipment. This is down 4.7 percent from 2001 in terms of jobs, and down 1.1 percent in terms of shipments. Compared to 2000, the number of jobs lost is 8 percent and shipments are down 6.5 percent.

The U.S. plastics industry is going through a transformation. It retains its strong export surplus in resins, but its trade in molds and machinery remains in deficit, and its plastics products trade has swung from surplus to deficit in the last two years. The U.S. plastics trade balance with China has deteriorated especially fast.

On a global basis, the industry had a large and growing trade surplus over the past decade. That trend, however, appears to have been reversed starting in 2001 with net exports falling 23.3% in 2002. Total plastics industry imports rose 6.9% and reached $24 billion in 2002. The biggest problem was plastics products, as defined by Chapter 39 of the Harmonized Tariff Schedule, which went from an $894 million trade surplus in 2000 to a $1.4 billion trade deficit in 2002. Plastics products imports grew 8.9% to $14.7 billion in 2002.

More importantly, the net trade deficit of plastics *contained* in *all* traded goods has grown significantly. The net trade deficit of plastics contained trade in 1997 was $4.2 billion. In 2002, it was $14 billion. That is an increase of 26.9 percent annually.

The causes of the deterioration of the U.S. plastics trade surplus to a rapidly increasing plastics trade deficit needs to be understood, especially with regard to the double-digit growth in imported Chinese products. Much of the deterioration in the plastics industry trade balance has been with China. Where it is due to deleterious domestic and international policies that have coalesced to drive plastics processors out of business or offshore and forced workers into unemployment, U.S. policymakers must undertake efforts to change these policies. If unfair trade practices are responsible, then the U.S. must use its resources to address and rectify such policies. Trading partners, including China, must operate consistent with U.S. trade laws and international trade rules, and enforce their World Trade Organization (WTO) commitments. We want to compete with the Chinese on a fair and level playing field both internationally and in our domestic marketplace.

During the past couple of years, many SPI members have become increasingly alarmed that unfair Chinese competition may be destroying U.S. plastics manufacturing.

- SPI member companies have anecdotal evidence that China is producing plastics finished goods for *less* than the cost of the raw materials in the U.S. There is also evidence that some material prices in China are approximately half the price of the same materials sold in the U.S. The result is that these imports are being offered for sale at prices so low that U.S. companies cannot compete.
- Some plastics processors are being forced to move operations offshore not only to take advantage of lower cost production, but also to avoid the higher costs of manufacturing in the U.S. due to ever-increasing costs such as energy, health care, and frivolous law suits.
- There are reported widespread Intellectual Property Rights violations in China that are continuing unabated despite its accession to the WTO and to the intellectual property rights agreements signed by WTO signatories.

Examples of Plastics Business Lost to China

In 2003 a plastics cutlery and house wares manufacturer lost 14% of his sales valued at $4 million to imports from China. The imported products are being sold for less that the U.S. manufacturer's raw material cost alone. The manufacturer says he cannot understand how this is possible when the products have to be made then shipped half way around the world. Lower-wage Chinese labor is not the issue because the manufacturing process is quite automated. This manufacturer would like to see the U.S. government do a study to understand how his prices can be so undercut by the Chinese. To retain customers, the manufacturer has had to lower selling prices while absorbing higher raw material prices that have resulted from high natural gas prices in the U.S. This company has done a lot to hold its own successfully against U.S. and European competitors but is worried about the impact on his business from the increasing imports from China. The manufacturer is concerned that his lost profits means less money to invest in the company to help ensure its future and the jobs of his employees.

A medical device manufacturer makes Class II patented medical devices which are registered with the FDA and sells them internationally. He discovered that unauthorized copies of his patented products made in China were being offered for sale in Canada. For this manufacturer, the lack of enforcement of Intellectual Property Rights is his biggest concern for the long-term viability of his business because he is convinced that China is developing the capability to make and copy increasingly sophisticated products.

A household goods manufacturer found his product for sale in Europe packaged to look like it was his, including the Made-in the USA label. But the U.S. manufacturer didn't make it here or anywhere. It came from China, including the Made in the USA label!

A packaging company lost a $600,000 per month customer to China for whom he had already cut his price to the bone. The packaging company believes it is THE low cost producer in the U.S.

A molder and tool maker lost a contract on tooling that was 60% less and on a widget that used commodity resin that was priced at a level that made it unprofitable for him.

A medical molder that makes proprietary stints for the medical imaging market had his product knocked off overseas for sale in less regulated markets overseas.

A film manufacturer that makes substrates for tape was approached by Chinese representatives about locating a plant in China that would have insured him fixed costs on lease holds and other benefits that he cannot duplicate even in the rural South.

SPI has not undertaken any studies specific to China plastics production costs and trade practices that support suspicions of unfair trade practices. However, SPI contracted for a trade study by Probe Economics [1] that looks at U.S. plastics import and export data, the results of which are cited below. The SPI trade study concludes that:

Plastics Industry Imports From China—Probe Economics

- *Total plastics industry imports from China increased 17.4% in 2002 and reflect an annual growth rate of 14.3%.*
- *In 2002, the U.S. had a $3.8 billion trade deficit in plastics products with China. China accounted for 27% of the plastics products imports in 2002, and Chinese imports have been growing at double-digit rates. U.S. imports from China have grown at a compound rate of 13.5% since 1997.*
- *The imports from China had been mostly consumer goods, like trays, cups, plates, curtains and kitchenware—the kinds of things that are sold by Wal-Mart. Increasingly, we are seeing items like doors, windows, blinds, shutters and builders' wares—the kinds of products that are sold by Home Depot and Lowe's. This doesn't include the many plastics products coming from China that are contained in other products, such as automobiles and TV sets.*
- *When plastics products contained in other goods are considered, the U.S. trade deficit in plastics products from China has swelled to $$7.6 billion in 2002, an annual increase of 16.4 annually since 1997 representing 54.6% of the total U.S. plastics trade deficit in 2002.*

The trade study notes that the U.S. previously had a trade surplus in plastics because the country had: (A) a large home market, which provided scale economies, (B) relatively low feedstock costs, (C) good logistics, especially in the Gulf Coast, and (D) some of the best technologies. The report states:

- *As to why the balance is deteriorating, first of all, the U.S. has lost its energy and feedstock advantage. For years, U.S. manufacturing enjoyed natural gas costs which were below crude oil prices on a Btu basis. Most of the world had to base its energy on crude oil. The U.S. gas surplus has run out. Natural gas prices have been rising relative to crude oil prices for some time in the U.S. and now are at or above parity levels. Other principal reasons are the high dollar value and the movement of manufacturing to Asia—especially China.*
- *The plastics industry serves manufacturing, providing raw materials and finished components. The biggest problem for the plastics industry today is that U.S. manufacturing is losing out to imports.*
- *Imports and exports represent a growing share of the U.S. plastics industry. Imports grew from 7% of annual shipments in 1992 to 12.3% in 2002.*
- *The U.S. has a significant and growing plastics products trade deficit with China. The biggest problem that China poses, however, is not in exports of plastics products per se, but in the usurpation of the markets for these products. In other words, China is taking over manufacturing—especially assembly operation.*

[1] "U.S. Plastics Industry Trade Through 2002; Trends, Partners, Hot Products, and Impacts on Employment" prepared by Probe Economics, Inc. for The Society of the Plastics Industry, Inc. August 2003

Because of the need for 'just in time' delivery to manufacturing sites, the associated manufacture of plastics products is also moving to China.

International Trade and Domestic Policies Need to Be Addressed

International trade and domestic policies need to be addressed by policymakers to improve the competitive environment for U.S. industry including plastics. Many policies significantly increase the manufacturing costs in the U.S., some policies and practices put U.S. products at a disadvantage in the global marketplace, and other policies are inadequately implemented thus contributing to a weakened manufacturing base.

Because SPI believes that U.S. manufacturing including the plastics industry remains critical to America's economic success and security, it is essential to modify policies that collectively are making it increasingly more difficult for U.S. manufacturers to compete in the global marketplace. We urge policymakers to change policies that hinder U.S. manufacturing and adopt approaches that best advance manufacturing competitiveness.

Economic stimulus efforts have been supported by the White House and enacted by Congress, and recent indicators suggest a recovery is underway. However, that good news has yet to translate to the manufacturing segment of this economy. Therefore, many in the plastics industry remain very concerned that their businesses and the industry are threatened by a global marketplace in which they find it increasingly difficult to compete.

China has become a manufacturing powerhouse. Its central and local government policies have supported development of key industrial sectors. Since the 1990's, China has become a global supply chain for many traded products and has seen its share of global trade in manufactured goods triple.

In the meantime, there is increasing unease in the U.S. over the declining share of manufacturing output and employment in our overall economy. And this is happening while China's currency—the yuan—remains pegged to the U.S. dollar at a rate set by government fiat nine years ago. Many believe that this maintains an artificially undervalued currency.

Congress needs to understand the impact of China's growth as a manufacturing powerhouse on the U.S. economy and security, particularly on the U.S. manufacturing sector. Congress needs to understand the relocation of manufacturing, high-technology, and R&D facilities to China and the implications of these transfers on the United States' national security, employment and the standard of living of the American people.

Are China's governmental policies—currency valuation, stimulation of exports, industrial capacity building policies, and non-compliance with WTO mandates—contributing to an unfair trading advantage detrimental to U.S. economic and security interests? SPI thinks that the answer is yes.

China's Currency Policy

SPI believes that China continues to follow a policy of one-way market interventions to maintain its currency at a level that economists estimate is between 15–40 percent undervalued. We believe that the artificially undervalued Chinese yuan is having a serious adverse impact on the competitiveness of U.S. manufactured goods and is contributing to a migration of world manufacturing capacity to China, and to an erosion of the U.S. manufacturing base. We believe that China is in violation of both its IMF and WTO obligations by manipulating its currency for trade advantage. Therefore, we think that the Treasury Department must immediately enter into negotiations with the Chinese Government to successfully resolve this matter. Otherwise, China's continued maintenance of an undervalued exchange rate with the U.S. dollar will continue to promote major distortions in trade and investment, to the detriment of American companies and workers, including plastics.

SPI also is concerned that the banking system in China is structurally weak. SPI urges the Administration to address this issue with the Chinese Government. For U.S. economic strength, it is imperative to maintain stability in the financial markets in the Asian region.

China's Industrial Policies and WTO Non-Compliance

China has attracted a total of over $400 billion of foreign direct investment (FDI), most of it in the last six years. This compares with $1.3 trillion for the U.S., $497 billion for the U.K., $482 billion for Belgium-Luxemburg, and $480 billion for Germany. As FDI flows to China are now expanding by over $50 billion per year, China will soon have accumulated the second largest amount of FDI in the world.

Experts have concluded that China's undervalued currency is just one of several factors behind its success in attracting massive inflows of FDI, particularly into its manufacturing sector. China has pursued industrial policies that have catalyzed its growth as a manufacturing powerhouse. The Chinese Government has designated a number of "pillar industries," for which it provides preferential benefits for domestic development and foreign investment. Manufacturers in China are supported through a wide range of national industrial policies, which include: tariffs; limitations on foreign firms' access to domestic marketing channels; requirements for technology transfer by foreign investors; government selection of partners for major international joint ventures; preferential loans from state banks; privileged access to listings on national and international stock markets; tax relief; privileged access to land; and direct support for R&D from the government.

Some of these industrial practices violate China's WTO obligations. The Administration needs to engage more forcefully with the Chinese Government where it violates China's commitments under the World Trade Organization (WTO).

Importance of Manufacturing to the U.S. Economy

In his September 15, 2003 remarks to the Detroit Economic Club, Commerce Secretary Don Evans stated that *"the President believes that our economic and national security require a stable, robust manufacturing sector that produces sophisticated and strategically significant goods here, in the United States."* While manufacturing employs 14 percent of the American workforce, it has accounted for nearly 90 percent of all the job losses since total U.S. employment peaked in March 2001. Over 2.7 million American manufacturing jobs have been lost over the past three years, roughly one in every six manufacturing jobs.

SPI was heartened when the Administration announced the President's Manufacturing Initiative earlier this year and we look forward to reviewing its proposals for dealing with the China-related concerns as well as with domestic policies. We think that China's undervalued currency and government industrial policies are having an adverse impact on the competitiveness of U.S. manufacturing and contributing to a migration of world manufacturing capacity to China, with a concurrent erosion of the U.S. manufacturing base.

Domestic Policies

SPI also believes strongly that in addition to international policies, U.S. domestic policies have played a major role in the decline of manufacturing in this country. Congress and the Administration must understand the urgency in changing domestic policies that are, in effect, forcing U.S. manufacturers to relocate overseas. Some of these domestic policies are noted below.

Energy—The plastics industry is doubly dependent on energy—not only for power for this energy-intensive industry but for its feedstocks as well. Of those feedstocks, 70 percent come from natural gas. The plastics industry has lost its energy and feedstock advantage. For years, natural gas costs in the United States were below crude oil prices on a Btu basis. Most of the world had to base its energy on crude oil. U.S. natural gas prices in the last couple of years have been at or above parity, thereby becoming a significant factor hurting competitiveness. Congress should adopt a balanced, comprehensive policy that will assure adequate supply of multiple sources of affordable energy plus a secure and reliable supply of reasonably-priced natural gas for U.S. manufacturing.

Health Care Insurance—Rapidly rising health care costs are the largest cost increase for many manufacturers. We need policies that contribute to lowered costs and greater access to health care including passage of federal Association Health Plan (AHP) legislation.

Tax—Tax rules affecting trade and international business need to be reformed and simplified. The U.S. must resolve the WTO Foreign Sales Corporation/ Extraterritorial Income case in such a way as to avoid EU trade retaliation while keeping U.S. manufacturers competitive. Congress must address the WTO ruling on taxation of extraterritorial income with either tax credits for manufacturers or lowered corporate tax rates for U.S. manufacturing that will make U.S. manufacturers more competitive.

Legal/Tort Reform—Litigation including that related to product liability has been one of the significant and growing contributors to the increasing cost of manufacturing in the U.S. Congress should adopt reforms to eliminate abuses of the current tort system that are destroying jobs and undermining the U.S. economy and the civil justice system.

Skilled Workforce—Surveys have found that many manufacturers face a shortage of skilled workers, and that many workers and applicants need training in the basic skills of reading, writing and math. Also, many employers have lacked the resources to provide technical training and the development of basic skills, especially during the economic downturn of the last couple of years. Congress should expand policies such as the Workforce Investment Act to help ensure that American industry will have the essential skilled workforce.

Conclusion

The plastics industry is stepping up to the challenge by continuing to innovate and further increase productivity to compete in the global marketplace. We cannot, however, win the battle alone. We implore our nation's leaders to recognize the importance of U.S. manufacturing to the overall economic health of the U.S. and its sustainability, and to take appropriate actions.

We would like to close with a quote from an SPI member who is working creatively to compete in this increasingly global marketplace. Among nearly 12,000 industry workers who recently signed a Plastics Manufacturing Matters petition supporting U.S. policies to encourage plastics manufacturing growth in this country, he expressed the following: "Our company has been in business for 32 years. We don't fear our [global] competition; we fear playing in a game with different rules and standards for the players. Please help my father keep a legacy for our family, our employees, our community and our country."

SPI thanks the Chairman for providing SPI the opportunity to put its concerns regarding China on the record. We look forward to the committee's continued efforts on this critical matter and would like to work with you wherever possible.

Statement of Roger W. Robinson, Jr., U.S.-China Economic & Security Review Commission

The U.S.-China Economic and Security Review Commission commends the Committee for holding this important hearing and appreciates the opportunity to apprise the Committee of its work in this area. The creation of the Commission itself demonstrates Congress' growing focus on U.S.-China economic relations and the implications of this relationship for U.S. economic and national security interests.

In America, people in varying capacities—business, labor, academia, the media and government—need to better understand the almost tectonic forces now shaping the U.S.-China economic relationship. With increasing sophistication, China has become a manufacturing powerhouse. Its central and local government policies have supported development of key industrial sectors. In the 1990's, China became embedded in what has become a global supply chain for many traded products and saw its share of global trade in manufactured goods triple.

In the meantime, there is increasing unease in the U.S. over the declining share of manufacturing output and employment in our overall economy. And this is happening while China's currency—the yuan—remains pegged to the U.S. dollar at a rate set by government fiat nine years ago. What are the causes and effects here? What are the key linkages? Are there steps the U.S. should be pursuing to remedy these challenging and, in some cases, debilitating circumstances?

Our Commission is mandated by Congress to examine, among other areas, China's economic policies and the United States' trade and investment relationship with China, including assessing the qualitative and quantitative nature of the shift of United States production activities to China. This latter charge includes examining the relocation of high-technology, manufacturing and R&D facilities to China and the effect of these transfers on United States national security, employment and the standard of living of the American people.

To begin to address these vitally important questions, the Commission held a full-day hearing on September 25, 2003, entitled: "China's Industrial, Investment and Exchange Rate Policies: Impact on the United States." Our hearing was designed to investigate the impact of China's growth as a manufacturing powerhouse on the U.S. economy, particularly on the U.S. manufacturing sector. We invited academic experts and representatives of business, industry and labor to provide us their perspectives on these issues. We examined whether China's governmental policies were contributing to an unfair trading advantage detrimental to U.S. economic interests. In this regard, we focused on China's policies regarding its currency valuation, stimulation of exports, industrial policies, and incentives to inward investment and research and development.

We benefited from the views of seven Members of the House and Senate who appeared at the start of our hearing. These Members—representing both sides of the aisle—described their concerns, and the concerns of many of their constituents, regarding the negative impact on U.S. manufacturing of China's currency and industrial policies. Several of these Members have introduced legislation aimed at providing appropriate incentives to the Chinese Government to cease its policy of maintaining, through a firm peg to the U.S. dollar, an artificially undervalued currency. Some argued for U.S. action against other unfair Chinese trade practices such as export subsidies, dumping, intellectual property theft, and other WTO-inconsistent practices.

At the conclusion of the hearing, the Commission weighed the testimony it had heard and came to some conclusions about the dynamics at work as well as some initial recommendations for U.S. Government action. These findings are recommendations were transmitted to Congress along with the full record of our hearing. I am pleased to provide you here with a summary of these findings and recommendations, which the Commission hopes will be helpful to your deliberations in this area.

China Exchange Rate Policies

Based on our examination of this issue, it appears clear that China continues to follow a policy of one-way market interventions by the government to maintain its currency at a level that economists estimate is between 15–40 percent undervalued. In this regard, China is purchasing U.S. dollars at an estimated rate of $120 billion per year to prevent appreciation of its currency against the dollar. In assessing causes of the worsening U.S. trade deficit and loss of U.S. manufacturing jobs, a broad range of factors are clearly at work; the lack of net new savings in the U.S. economy, the global mobility of factors of production and low labor costs in China are among the principal factors. However, we believe that the artificially undervalued Chinese yuan is negatively impacting the competitiveness of U.S. manufactured goods and is contributing to a migration of world manufacturing capacity to China and to an erosion of the U.S. manufacturing base.

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 (22 U.S.C. Sec. 5304) requires annual reports from the Department of Treasury on foreign countries' exchange rate policies and requires the Secretary to enter into negotiations on an expedited basis with countries found to be manipulating their currencies to gain an unfair competitive trade advantage. Past reports from the Treasury on China have sidestepped this conclusion, which appears now to be inescapable. *The Commission believes it is clear that China, in violation of both its IMF and WTO obligations, is in fact manipulating its currency for trade advantage and therefore finds it imperative that the Treasury immediately and forcefully enter into negotiations with the Chinese Government to resolve this matter*. China's continued maintenance of an undervalued exchange rate with the U.S. dollar will continue to promote major distortions in the flow of trade and investment, to the detriment of American companies and workers, and therefore requires decisive action by Washington.

Given these findings, the Commission made the following recommendation to Congress:

> **Recommendation**: The Treasury Department should make a determination in its foreign country exchange rate report to Congress that China is engaged in manipulating the rate of exchange between its currency and the U.S. dollar to gain an unfair competitive trade advantage and immediately enter into formal negotiations with the Chinese Government over this matter. Should these efforts prove ineffective, the Commission urges the Congressional leadership to use its legislative powers to force action by the U.S. and Chinese Governments to address this unfair and mercantilist trade practice. For the near future, continued vigorous development of such legislative initiatives as were outlined by Members of Congress during our hearing, linking China's performance on its exchange rate policies to its continued full access to the U.S. market, appears essential to ensure the appropriate level of effort by both Governments to this matter.

China's Investment and Industrial Policies

China has attracted a total of over $400 billion of foreign direct investment (FDI), most of it in the last six years. This compares with $1.3 trillion for the U.S., $497 billion for the U.K., $482 billion for Belgium-Luxemburg, and $480 billion for Germany. As FDI flows to China are now expanding by over $50 billion per year, China will soon have accumulated the second largest stock of FDI in the world.

Our hearing indicated that China's undervalued currency is just one of several factors behind that country's success in attracting massive inflows of FDI, particularly into its manufacturing sector. Our hearing examined the extent to which China's industrial policies have played a role. In this regard, we learned that:

- China has pursued industrial policies that have catalyzed its growth as a manufacturing powerhouse, particularly in increasingly higher-technology production. The Chinese Government has designated a number of "pillar industries," particularly in the high-tech area, for which it provides preferential benefits for domestic development and foreign investment.
- Manufacturers in China are supported through a wide range of national industrial policies, which include: tariffs; limitations on foreign firms' access to domestic marketing channels; requirements for technology transfer by foreign investors; government selection of partners for major international joint ventures; preferential loans from state banks; privileged access to listings on national and international stock markets; tax relief; privileged access to land; and direct support for R&D from the government budget.

Some of these industrial practices fall outside the parameters of China's World Trade Organization commitments, however others appear to violate China's stated WTO obligations. The U.S. Government needs to engage more forcefully with the Chinese Government where they appear to violate China's commitments under the World Trade Organization (WTO). The Congress needs to be regularly briefed on progress and removing these barriers so as to keep the pressure on our trade regulators and enforcers to hold China to its commitments.

Recommendation: The United States Trade Representative and the Department of Commerce should identify whether any of China's industrial policies are inconsistent with its WTO obligations and engage with the Chinese Government to mitigate those that are significantly impacting U.S. market access. Appropriate Congressional Committees should be fully briefed on the actions the agencies are taking to resolve these issues.

With trade and investment flows rapidly growing between the U.S. and China, it has become increasingly difficult for interested parties to have a clear understanding of all the dynamics at work. In order to fashion effective government policy, a better picture of the trade and investment relationship is needed.

Recommendation: The Commission also believes it is essential that U.S. policymakers have a clearer, more comprehensive, and timely picture of global investment and R&D flows to China, particularly in the manufacturing sector. The Commission's 2002 Report to Congress urged Congress to consider establishing an enhanced, mandated corporate reporting system to capture better this information by requiring firms to report "their initial investments in China; any technology transfer, offset, or R&D cooperation agreed to as part of the investment; the shift of production capacity and job relocations resulting from the investment, both from within the United States to overseas and from one overseas location to another; and contracting relationships with Chinese firms." We believe the need for such a system has only increased in urgency since our 2002 Report and again urge Congress to consider taking such action.

Impact on U.S. Economy

In his September 15, 2003 remarks to the Detroit Economic Club, Commerce Secretary Don Evans stated that *"the President believes that our economic and national security require a stable, robust manufacturing sector that produces sophisticated and strategically significant goods here, in the United States."* Manufacturing employs 14 percent of the American workforce, but has accounted for nearly 90 percent of all the job losses since total U.S. employment peaked in March 2001. Over 2.7 million American factory jobs have been lost over the past three years, roughly one in every six manufacturing jobs.

We are awaiting the release of the President's Manufacturing Initiative and look forward in particular to reviewing its proposals for dealing with the China-specific challenges. It is our opinion that that China's undervalued currency and government investment strategies are having a deleterious effect on the competitiveness of U.S. manufactured goods and contributing to a migration of world manufacturing capacity to China, with a concurrent erosion of the U.S. manufacturing base.

Recommendation: The Commission recommends that the President's pending Manufacturing Initiative should include provisions that strengthen the competitiveness of U.S.-based manufacturers in light of the growing shift of production to China, especially high-tech and R&D. The Initiative should address de facto Chinese Government subsidies, including those not covered under the WTO, such as tax incentives, preferential access to credit, capital, and materials, and investment conditions requiring technology transfers.

Engaging forcefully with China over its currency valuation, over its WTO non-compliant practices, and over practices that, even if outside the strictures of the WTO agreement, are operating to inappropriately disadvantage U.S. exporters is not a "get tough" policy attempting to hold China to a higher standard than other trading partners. It is a necessary and appropriate U.S. response to bring a major trading partner around to the spirit and letter of the commitments it agreed to in the interest of forging a mutually beneficial economic relationship.

When China joined the WTO, part of the bargain was that it agreed to be subject to three China-specific safeguard provisions that lowered the threshold for bringing WTO trade disputes against China: a non-market economy methodology in anti-dumping cases, a product-specific safeguard that allows WTO members to restrain Chinese imports that disrupt their domestic markets, and a textile safeguard. These provisions were pursued in recognition of China's still developing market economy and are an important means to maintain a level playing field for China's trading partners. As we recommended in our 2002 Report to Congress, we urge USTR and the Commerce Department to make aggressive use of these safeguards to minimize the potentially severe dislocations to our economy during China's transition into the WTO.

In the coming months, the Commission will hold hearings on a number of issues pertinent to the Committee's work. In December we will examine how China's emergence as an economic and military power is impacting other nations in Asia and how this affects U.S. interests in the region. We also plan to hold a hearing in the near future on China's WTO compliance record where we will review the official reports of China's compliance—those issued by USTR and the WTO—and compare them with assessments offered by industry, labor and other key stakeholders. We also intend to carefully examine the Administration's Manufacturing Initiative once it is released and how it addresses the concerns we have outlined above.

Early next year, the Commission will hold hearings on China's military modernization, U.S. science and technology transfers to China and a security-minded review of Chinese fundraising activities in the U.S. capital markets. The fruit of all this work will be embodied in our second Annual Report for the Congress due out next Spring.

It is the hope of the Commission that our work will help inform your deliberations and contribute to the fashioning of legislation by the Congress which will illuminate the dynamics of the U.S.-China economic and security relationships, better identify unfair Chinese trade practices, identify emerging threats to U.S. national security interests, and steer Chinese economic practice into more sustainable and fairer channels. Thank you again for this opportunity to provide our views on the issues before you.

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